Canadian-Japanese Economic Relations in a Triangular Perspective

C.D. Howe Institute

Edited by
Wendy Dobson

87-03343/

C.D. Howe Institute

The C.D. Howe Institute is an independent, nonpartisan, nonprofit research and educational institution. It carries out, and makes public, independent analyses and critiques of economic policy issues and translates scholarly research into choices for action by governments and the private sector.

The Institute was created in 1973 by a merger of the C.D. Howe Memorial Foundation and the Private Planning Association of Canada. The Foundation had been created in 1961 to memorialize the late Right Honourable C.D. Howe, who served Canada in many elected capacities between 1935 and 1957, including as Minister of Trade and Commerce. The Private Planning Association of Canada was a unique forum created in 1958 by leaders of business and labor for the purpose of carrying out research and educational activities on economic policy issues.

While its focus is national and international, the Institute recognizes that Canada is composed of regions, each of which may have a particular perspective on policy issues and different concepts of what should be national priorities.

A Board of Directors is responsible for the Institute's general direction and for safeguarding its independence. The President is the chief executive and is responsible for formulating and carrying out policy, directing research, and selecting staff. In order to promote the flexibility and relevance of its work, the Institute's high-quality professional staff is intentionally kept small and is supplemented by a program of visiting professionals and links with a number of scholars and compatible institutions.

Participation in the Institute's activities is encouraged from business, organized labor, trade associations, and the professions. Through objective examinations of different points of view, the Institute seeks to increase public understanding of policy issues and to contribute to the public decisionmaking process.

Grant L. Reuber is Chairman, Maureen Farrow is President and Treasurer, and Margaret Brouxhon is Corporate Secretary.

The Institute's offices are located at: Suite 900, 555, boul. Dorchester ouest, Montréal, Québec H2Z 1B1; P.O. Box 1621, Calgary, Alberta T2P 2L7; and 125 Adelaide Street East, Toronto, Ontario M5C 1L7.

Canadian-Japanese Economic Relations in a Triangular Perspective

edited by
Wendy Dobson

Observation No. 30
C.D. Howe Institute

C.D. Howe Institute publications are available from:

Prentice-Hall Canada Inc.
1870 Birchmount Road
Scarborough, Ontario
M1P 2J7
(416) 293-3621

Canadian Cataloguing in Publication Data
Main entry under title:

Canadian-Japanese economic relations in a triangular perspective

(Observation, ISSN 0826-9947; no. 30)
Papers by Wendy Dobson and Hideo Sato.
Includes bibliographical references.
ISBN 0-88806-139-0

1. Canada – Foreign economic relations – Japan.
2. Japan – Foreign economic relations – Canada.
3. Canada – Foreign economic relations – United States.
4. United States – Foreign economic relations – Canada
5. Japan – Foreign economic relations – United States.
6. United States – Foreign economic relations – Japan.
I. Dobson, Wendy. II. Sato, Hideo, 1942–
III. C.D. Howe Institute. IV. Series: Observation
(C.D. Howe Institute); no. 30.

HF1480.5.J3C36 1987 337.71052 C87-093758-8

Quotation with appropriate credit is permissible.
C.D. Howe Institute, Toronto, Montreal, and Calgary.
Printed in Canada — April 1987.

Contents

Foreword v

A Canadian Perspective, *by Wendy Dobson* 1
The Triangular Relationship Today 2
Major Influences on the Future of Canadian-Japanese Economic Relations 11
Implications of a North American Trade Agreement for Canadian-Japanese Economic Relations 19
Conclusion 28
Appendix 31

Figures
1 Trade Flows Among Canada, Japan, and the United States, 1985 (as a percentage of bilateral GNP) 3
2 Exports Among Canada, Japan, and the United States, 1985 ... 4
3 Imports Among Canada, Japan, and the United States, 1985 ... 5
4 Net Capital Flows Among Canada, Japan, and the United States, 1982–85 6

Tables
1 Savings, Investment, and External Current Account in Canada, Japan, and the United States, 1970–85 9
2 Commodity Composition of Canadian-U.S.-Japanese Trade Flows, 1975 and 1985 20
A-1 Bilateral Merchandise Trade Flows, Canada, Japan, and the United States, 1971–85 33
A-2 Bilateral Merchandise Exports, Canada, Japan, and the United States, 1971–85 34
A-3 Bilateral Merchandise Imports, Canada, Japan, and the United States, 1971–85 35

A Japanese Perspective, *by Hideo Sa'o* 37
Japan as Canada's "Third Option" 39
Canada's Ride on the Coattails of the United States 46
Special Treatment for Canada 50
Conclusion 53

Figures

1 Trade Flows Among Canada, Japan, and the United States, 1984 38
2 Canada's Trade with Japan, 1965–84 40
3 Major Canadian Exports to Japan, 1974 and 1980 41
4 Canada's Trade with Japan, by Region, 1982 42
5 Composition of Canadian Trade with Japan and the United States, 1981 43

Table

1 U.S. Trade with Japan, 1985 44

About the Authors 55

Foreword

Japan's increasing economic influence in the world at a time when U.S. influence is waning has unleashed myriad speculations about the future evolution of global patterns of trade and investment, about the evolution of international institutions, and about relationships between Japan and other countries. Many countries seek to increase their economic relations with Japan. Canada is one of them.

The studies in this volume examine the political economy of Canadian-Japanese trade and investment relations. Both authors acknowledge, however, that without recognizing the high level of interdependence between the Canadian and Japanese economies and that of the United States, the two-way picture is incomplete. Both studies thus proceed from the premise that a realistic bilateral picture is only possible in the context of the "triangular" economic relationship with the United States.

Much has been written about the Canadian-U.S. and Japanese-U.S. bilateral relations. That literature is not reviewed here. Instead, in the first study, a Canadian looks from a Canadian perspective at the Canadian-Japanese relationship in the triangular context. The study was undertaken by Dr. Wendy Dobson, President of the C.D. Howe Institute until the end of February 1987, with the assistance of Bruce Ewen, Policy Analyst. She examines two major influences on future economic integration between Canada and Japan, paying particular attention to the advantages and disadvantages of the Canadian-U.S. free trade negotiations that are now under way, and to the changing Canadian policy climate for foreign investment. This paper grew out of a speech Dr. Dobson delivered in Nagoya, Japan, in May 1986 to the Canada-Japan Businessmen's Co-operation Council. The text of the speech received extensive comment from Japanese academics, policy analysts, and business people. The present study takes account of many of these comments, particularly with respect to the impact of Canadian-U.S. trade negotiations.

The second study, prepared by Japanese scholar Dr. Hideo Sato, of Tsukuba University, was the subject of a research seminar held at the C.D. Howe Institute in July 1986. Dr. Sato is in the midst of a historical study of Canadian-Japanese economic relations. His paper, based on a political analytical framework, provides an insightful Japanese perspective that is unique for Canadian readers.

This volume is intended to stimulate debate and further enquiry into the history and future of the Canadian-Japanese economic relationship, and is aimed at a public rather than an academic audience. It is based

on the assumption that, in both countries, such studies can enhance public sensitivity to and understanding of factors influencing the bilateral relationship.

The focus of the volume is also on the Canadian side of the relationship. Future studies will have to examine in more depth the significance of the Japanese policy environment and factors influencing greater Canadian participation in the Japanese economy.

Financial assistance for this project from the Asia Pacific Foundation of Canada is gratefully acknowledged. The manuscripts were prepared by Cordelia Sharpe and Elaine Fitzpatrick; they were edited for publication by Barry A. Norris. As with all Institute publications, the conclusions are those of the authors and do not necessarily represent the views of the Institute's members or directors.

Edward A. Carmichael
Vice-President
March 1986

A Canadian Perspective

*Wendy Dobson**

The world's major economies are becoming more and more interdependent. Shifts in patterns of comparative advantage have increased their dependence on trade and their vulnerability to stiff international competition. Rapid technological change and financial innovation soon may eliminate most barriers to mobility of much of the world's capital flows. Rising affluence, better education, and the internationalization of labor markets have increased labor mobility and the exchange of knowledge and ideas. The growing importance of these international exchanges creates new opportunities for national economies. But they increase pressures and constraints on these economies as well. Economic policy in one country increasingly affects or is affected by economic policy and performance in other countries.

This study focuses on particular opportunities and pressures that a closer economic relationship between Canada and Japan may create. Any analysis of Canadian-Japanese relations would be incomplete, however, if it failed to take account of the fact that the United States is both countries' largest trading partner. By the mid-1980s, the United States had also become the main destination of capital outflows from both. These close linkages through trade, technology, and investment ties suggest that the major determinants of closer economic relations between Canada and Japan should be sought within this "triangular" context.[1]

The purpose of this study is to examine, from a Canadian perspective, some of the major factors that are likely to influence the future of the Canadian-Japanese "leg" of the Canadian-U.S.-Japanese economic triangle.[2] The first section examines the current state of the three bilateral

*Assisted by Bruce Ewen.

[1]Indeed, the structure of this argument can be extended to other small countries, such as Australia, that have major economic ties with Japan and the United States. For example, Japan sends 43 percent of its total exports to Canada, Australia, and the United States (with 37 percent going to the United States). More than 50 percent of Japan's food imports originate in these three countries and 40 percent of its basic materials, excluding oil.

[2]The framework for the arguments in this paper was presented to the Canada-Japan Businessmen's Co-operation Council in Nagoya, Japan, in May 1986. The paper has been developed subsequently to take account of comments and suggestions from Japanese businessmen, policy analysts, and public servants.

economic relationships, by looking at a statistical snapshot of trade and investment flows and then by illustrating, using three examples, how economic developments in one of the bilateral relationships can affect the third partner.

The second section focuses on the future of the Canadian-Japanese relationship and identifies two factors, originating in the triangle, that are likely to have a major influence. The third section examines in considerable detail the implications for Canada and Japan of one of these factors — the comprehensive trade negotiations under way between Canada and the United States. Finally, recognizing the links that can be created between trade and investment, the last section reviews recent developments in the Canadian investment climate.

The Triangular Relationship Today

The status and dynamics of the Canadian-U.S.-Japanese triangular relationship can be illustrated in two ways. The first way is to take a statistical "snapshot". The second is to show how seemingly straightforward policy developments in one or two members of the triangle, often taken to serve domestic goals and interests, can have unintended consequences for the third member.

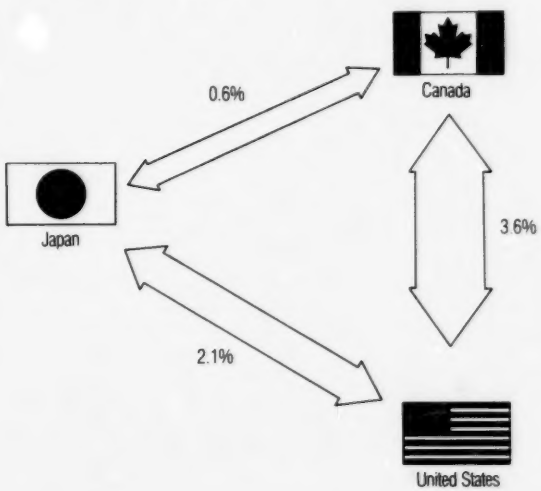
A Statistical Picture of the Triangle

Three characteristics of the triangular trade and investment relationships stand out in a statistical analysis. First, trade and investment links between the United States and Canada are extensive. Second, the trading relationships between the United States and Japan and between the United States and Canada are asymmetrical. The Canadian and Japanese economies depend much more on exports to the United States than the U.S. economy does on exports to either of them. Part of the reason for this asymmetry can be found in the impact of the strong U.S. dollar in the early 1980s. The strength of the dollar against the currencies of both partners made U.S. exports more expensive and Canadian and Japanese imports relatively cheaper. The third characteristic of the triangle is the relative insignificance of the trade and investment relationship between Canada and Japan.

These characteristics are illustrated in the economic triangles presented in Figures 1 to 4, which indicate the importance to each country's overall economic activity of flows of capital and trade to the other two. The figures present several key factors:

- The economies of Canada and the United States are highly integrated; indeed, 20 percent of U.S. exports go to Canada and 80 percent of

Figure 1
Trade Flows Among Canada, Japan, and the United States, 1985
(as a percentage of bilateral GDP)

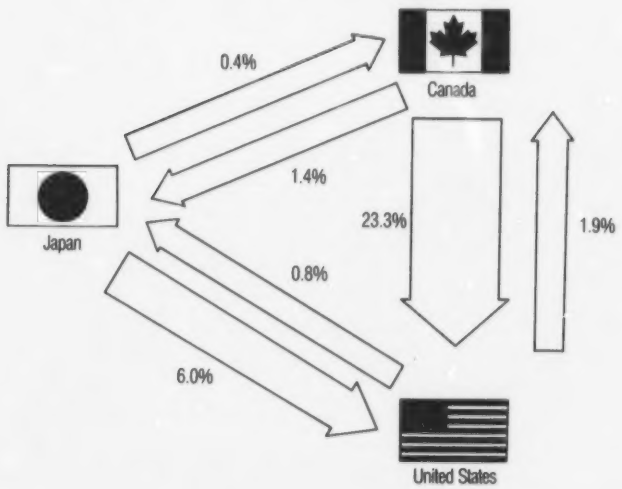


Sources: Statistics Canada, *Quarterly Estimates of the Canadian Balance of International Payments*, Cat. no. 67-001, 3rd quarter, 1986, pp. 15, 27; U.S. Department of Commerce, *Survey of Current Business*, June 1986, p. 65; Organisation for Economic Co-operation and Development, *Main Economic Indicators*, June 1986, p. 172.

Canadian exports currently go to the United States. Bilateral trade flows of goods and services accounted for as much as 4 percent of the two countries' combined GNP in 1984 (Figure 1).

- The Canadian-Japanese trade relationship is much less significant; two-way trade accounts for less than 1 percent of these two countries' combined output, even though this output is about one-third that of Canada and the United States (Figure 1).
- Canada is almost five times as dependent on exports than is Japan, sending nearly 25 percent of its output to the other two countries (Figure 2).
- Exports to the United States are a far more significant part of Canada's economic activity than they are of Japan's: 23 percent of Canadian, but only 5 percent of Japanese, production is exported to the United States (Figure 2).
- From the United States' perspective, Canadian imports are a far more important part of U.S. economic activity than are imports from Japan (Figure 3). Japanese analysts and some U.S. decisionmakers have

Figure 2
Exports Among Canada, Japan, and the United States, 1985
(as a percentage of exporting country's GDP)

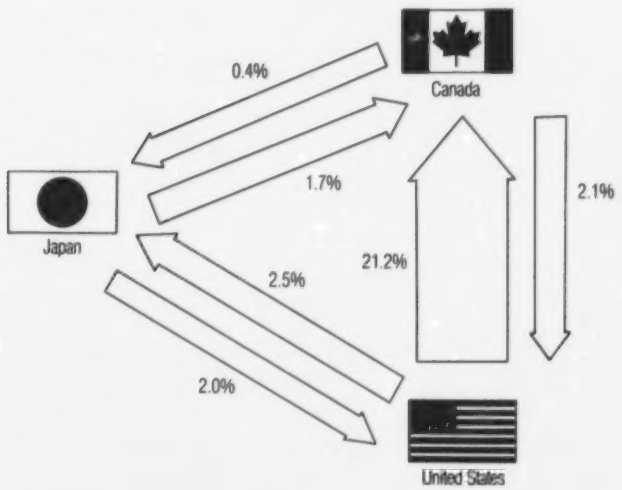


Sources: Statistics Canada, *Quarterly Estimates of the Canadian Balance of International Payments*, Cat. no. 67-001, 3rd quarter, 1986, pp. 15, 27; U.S. Department of Commerce, *Survey of Current Business*, June 1986, p. 65; Organisation for Economic Co-operation and Development, *Main Economic Indicators*, June 1986, p. 172.

questioned why, if this is so, the political impact of the U.S. trade deficit with Japan is so much more negative than its trade deficit with Canada. The answer, however, lies not in share analysis but in the magnitude of two-way flows. Japan's trade surplus with the United States consists of a large volume of exports, offset by U.S. exports to Japan that account for less than 1 percent of U.S. GNP. By contrast, Canada's large volume of exports to the United States is offset by U.S. exports to Canada that account for 2 percent of U.S. GNP. U.S. producers in a number of industries, including autos and a wide range of manufactured goods, thus have a much larger stake in the Canadian market than they do in the Japanese market.

- Japan's import penetration into the United States only slightly outweighs its import penetration into the much smaller Canadian economy (Figure 3).
- During the 1982–84 period, very little of the U.S.$3.6 billion in net capital flows from Japan to Canada represented direct investment

Figure 3
Imports Among Canada, Japan, and the United States, 1985
(as a percentage of importing country's GDP)



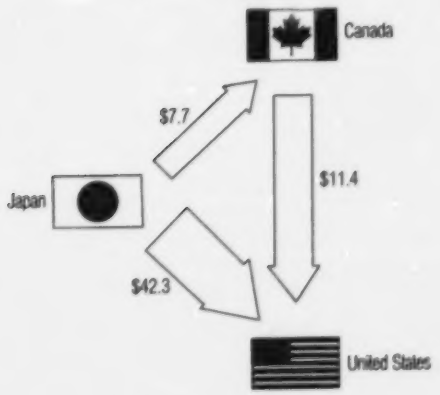
Sources: Statistics Canada, *Quarterly Estimates of the Canadian Balance of International Payments*, Cat. no. 67-001, 3rd quarter, 1986, pp. 15, 27; U.S. Department of Commerce, *Survey of Current Business*, June 1986, p. 65; Organisation for Economic Co-operation and Development, *Main Economic Indicators*, June 1986, p. 172.

(Figure 4). Direct foreign investment — as distinguished from portfolio capital flows, which include the acquisition of government and corporate bonds — is often accompanied by trade flows in the form of sales from or to the investor, frequently a parent company or partner in the joint venture. Very little increased trade activity resulted from Japanese capital flowing into Canada during this period.

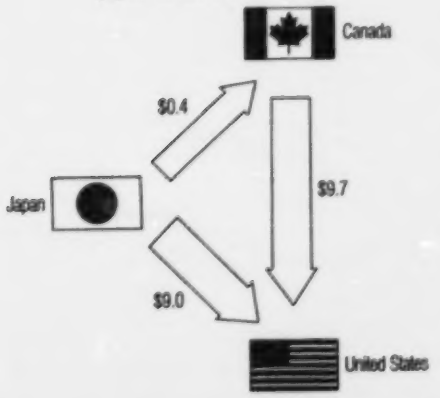
Historical comparisons of some of these relationships, presented in Appendix Tables A-1 to A-3, confirm that the 1985 snapshot is consistent with historical patterns, with one important exception. Trade relations in 1985 between the United States and both Japan and Canada are distortions of historical trends because of the temporary strength of U.S. demand for foreign imports in the early 1980s. Until February 1985, the U.S. dollar strengthened dramatically against the Japanese yen, making imports cheaper and U.S. exports more expensive than domestic goods and services.

Figure 4
Net Capital Flows Among Canada, Japan, and the United States, 1982-85
(cumulative, in U.S.$ billions)

(A) Overall Flows



(B) Net Direct Investment



Note: Data on capital flows between Canada and the United States are taken from Canadian sources. U.S. data underestimate these flows.

Sources: Statistics Canada, *Quarterly Estimates of the Canadian Balance of International Payments*, Cat. no. 67-001, various issues; U.S. Department of Commerce, *Survey of Current Business*, various issues.

The trade distortions introduced by the strong U.S. dollar are illustrated by the rising merchandise trade flows beginning in 1981 between the United States and Japan (Appendix Table A-1); by the rise in export dependency on the United States by the two smaller economies during the same period (Appendix Table A-2); and by the increased share of U.S. GDP represented by imports (Appendix Table A-3). In contrast, the trend in the Canadian-Japanese statistics changed hardly at all during this period.

Trade and investment flows between Canada and Japan have never been particularly significant to either country. The reasons are fairly obvious. Some relate to country-specific factors such as geographical distance, cultural differences, and low levels of bilateral political and historical ties. But two factors dominate the explanation. One is the small size of the Canadian market. The other is Canada's historically close economic and political relationship with the United States.

Japanese investors showed interest in Canada during the 1970s and early 1980s, a period of rising world prices and fears of growing scarcities of natural resources that Canada has in abundance. At the same time, however, Canada adopted policies — including the National Energy Program and nationalist practices of the Foreign Investment Review Agency — designed to discourage foreign investment.[3]

Japanese investors have also tended to view investment opportunities in Canada in the context of the entire North American market. In their view, this market is divided by the international border. Since one market is ten times the size of the other, it seems rational, especially in an increasingly protectionist world, to invest in productive capacity in the larger market and to export to the smaller one. Should trade barriers arise between Canada and the United States, loss of the smaller market would be a marginal one. For this reason, an apparent lack of Japanese interest in Canada in the mid-1980s is related to uncertainty about the security of Canada's access to the U.S. market. Canadians' own concerns about continued access have encouraged the bilateral trade initiative, which is discussed later. A resurgence of Japanese interest, beginning in late 1986, may relate to this initiative.

Policy Dynamics of the Triangular Relationship

Some of the dynamics of the triangular relationship can be illustrated by cases in which policies adopted by one country, or between two countries, have had complex and unintended consequences for the third country. Three such cases are described briefly below: the savings-investment

[3]See Edward A. Carmichael and James K. Stewart, *Lessons from the National Energy Program*, Observation no. 25 (Toronto: C.D. Howe Institute, 1983); and A.E. Safarian, *FIRA and FIRB: Canadian and Australian Policies on Direct Foreign Investment* (Toronto: Ontario Economic Council, 1985).

imbalance between the United States and Japan, and its impact on other countries — in this case, Canada;[4] the United States' request that Japan place voluntary export restraints on autos, and the impact of that request on Canadian policy options; and the relationship between Japan's tariff on lumber imports and Canadian-U.S. trade frictions.

The Savings-Investment Imbalance

Patterns of savings and investment are important influences on trade and capital flows between countries. If a country saves more than it invests in domestic economic activity, savings will flow abroad as investors seek better opportunities. Capital inflows will push up the exchange rate of the capital-importing country and reduce its current account balance as exports are made more expensive and imports cheaper. The net capital importer will thus be a net importer of goods and services as well.

Figure 4 illustrates the United States' net capital importer position during the 1982–84 period relative to that of Canada and Japan. This position developed during a period in which the United States became a major international borrower. Large U.S. federal budget deficits, caused by the Reagan administration's decisions to increase defense spending and cut taxes — which were not offset by spending reductions in other areas — created borrowing requirements that exceeded domestic savings. Business tax cuts provided a strong stimulus to investment at a time when financial markets were imposing high risk premiums on borrowers because of worries that public-sector borrowing either would be monetized, thus reigniting inflation, or would crowd out the private sector. High interest rates, robust growth, and rapidly growing investment attracted investors to the United States.

Two of the major suppliers of capital to the United States have been Canada and Japan. Since 1980, as Table 1 illustrates, while the investment share of U.S. GNP increasingly has outweighed domestic savings (see column F), the U.S. current account has moved into deficit (see column G). In Japan, on the other hand, savings have outweighed investment at the same time as the current account surplus has been growing. Canada's savings have also exceeded domestic investment. Although Canada has become a net exporter of capital to the United States since the late 1970s, its overall current account balance (column G) was negative until the early 1980s because of the large service account outflows that were required to service a large accumulated foreign debt and to pay dividends on accumulated foreign investments.

---

[4]For a detailed analysis of the U.S.-Japanese relationship, see C. Fred Bergsten and William R. Cline, *The United States-Japan Economic Problem* (Washington, D.C.: Institute for International Economics, 1985).

Table 1
Savings, Investment, and External Current Account in Canada, the United States, and Japan, 1970–85
(as percentage of GNP)

	Private savings			Private investment	Government balance	Savings-investment balance	Current account
	Personal (A)	Business (B)	Total (C)	(D)	(E)	(F=C−D+E)	(G)
Canada[a]							
1970	3.5	13.3	16.8	17.4	0.9	0.3	1.1
1975	7.3	12.6	19.9	20.3	−2.4	−2.8	−3.2
1980	8.5	14.8	23.3	20.5	−2.7	0.1	−0.7
1981	9.7	12.3	21.9	21.9	−1.6	−1.6	−2.1
1982	11.0	10.6	21.5	16.6	−5.0	−0.1	0.4
1983	9.3	13.8	23.1	16.6	−6.2	0.4	0.2
1984	9.3	14.2	23.5	16.2	−6.3	0.9	0.3
1985	8.3	13.6	21.9	16.8	−6.0	−0.9	−0.9
United States							
1970	5.6	10.4	16.0	14.5	−1.1	0.4	0.2
1975	6.1	12.2	18.2	13.3	−4.1	0.8	1.2
1980	4.2	12.4	16.5	15.3	−1.2	0.0	0.0
1981	4.6	12.6	17.2	16.4	−0.9	−0.1	0.2
1982	4.9	12.7	17.6	14.1	−3.5	0.0	−0.3
1983	3.6	13.6	17.4	14.7	−3.8	−1.1	−1.4
1984	4.5	13.4	17.9	17.6	−2.7	−2.4	−2.8
1985	3.6	13.6	17.2	16.5	−3.4	−2.7	−2.9
Japan[b]							
1970	11.5	22.0	33.1	33.9	1.8	1.0	1.0
1975	16.1	13.0	28.6	26.0	−2.7	−0.1	−0.1
1980	13.8	15.5	28.7	25.2	−4.4	−0.9	−1.0
1981	14.0	14.9	28.2	23.8	−3.8	0.6	0.4
1982	12.5	15.4	27.3	23.0	−3.6	0.6	0.6
1983	12.8	15.2	26.4	21.1	−3.7	1.6	1.8
1984	12.5	15.9	26.1	20.9	−2.2	3.0	2.8
1985	n.a.	n.a.	n.a.	n.a.	−1.4	n.a.	3.7

[a]Statistical differences between the savings-investment balance and the current account balance reflect the residual error of estimate in the National Accounts.

[b]For Japan, the sum of gross business savings and personal savings exceeds total private savings because of statistical discrepancies.

Sources: United States, Office of the President, *Economic Report of the President, 1985* (Washington, D.C.: U.S. Government Printing Office, 1985), pp. 232, 262, 321; *Federal Reserve Bulletin*, May 1985, p. A53; International Monetary Fund, *International Financial Statistics Yearbook 1984* (Washington, D.C., 1984), pp. 363-65, 595; Organisation for Economic Co-operation and Development, *Quarterly National Accounts*, 1984, p. 36; Statistics Canada, *National Income and Expenditure Accounts*, Cat. no. 13-001, various issues; and United States, Department of Commerce, *Survey of Current Business* 66 (July 1986), pp. 26, 57, 58.

The data in Table 1 illustrate the divergent savings-investment positions of Japan and the United States, as well as the related trade and capital imbalances. Japan, the net capital exporter in the bilateral relationship, is also the net exporter of goods and services. As this imbalance has persisted, protectionist pressures have grown in the U.S. Congress.

The savings-investment imbalance between Japan and the United States has important implications for Canada (and for other countries as well). One consequence is that the protectionist climate in the U.S. Congress, exacerbated by pressures from U.S. producers penalized by the strong dollar, has added to uncertainty about Canada's access to the U.S. market.

Another consequence is that the vulnerability of Canadian exporters to U.S. protectionist pressures has increased. The close linkage of Canadian and U.S. capital markets prevents sharp or prolonged divergence in interest rates in the two countries. If, for example, Canadian interest rates depart from U.S. rates, short-term capital flows quickly affect the exchange value of the Canadian dollar. Canadian monetary policy tended to follow U.S. policy in the early 1980s. The value of the Canadian dollar relative to third currencies rose along with the U.S. dollar during that period, putting Canadian exporters at a disadvantage in third markets. At the same time, the persistent depreciation of the Canadian dollar relative to the U.S. dollar, caused by net capital outflows, debt-servicing requirements, and a decline in Canada's terms of trade, increased the price attractiveness of Canadian exports in the United States. As a result, Canadian exporters' dependency on the U.S. market increased at the same time that U.S. protectionist pressures were rising.

Autos

The second example of the policy dynamics of the triangular relationship illustrates how developments in U.S.-Japanese relations have affected Canada's relations with Japan. During the early 1980s, Japanese auto producers succeeded in obtaining an increasing share of the U.S. market. In response to what it perceived as a threat to the domestic auto industry, the U.S. government threatened to impose domestic content requirements on Japanese auto imports and demanded voluntary export restraints (VERs) by Japanese producers. Japanese producers, in turn, responded to the threat of being denied access to the U.S. market by building several new plants in the United States to serve that market from a domestic base.

These developments had several effects on Canada, some of them adverse. First, the U.S. demand for VERs on Japanese autos created pressures in Canada for similar restraints on Japanese exports. Without some formal agreement, Japanese autos could have been expected to flood the Canadian market, swamping Canadian producers. Second, the Canadian

auto industry pressured Ottawa into insisting that more Japanese autos be produced in Canada.

The Japanese were slow to invest in Canada, for reasons already noted: one being their prime concern about uninterrupted access to the U.S. market from a Canadian plant and another being their uncertainty about Canadian policies and attitudes toward foreign investment.

Canada's response to the delay in Japanese investment was to hold up Japanese autos on the Vancouver docks. This action signaled Canada's seriousness about denying Japan access to the Canadian market. Soon after, Japanese producers agreed to VERs and, later, began to announce plans to invest in Canadian production facilities. What began as a U.S.-Japanese auto trade friction eventually led to Canada's pressuring Japanese auto producers to limit exports to and increase production in Canada.

Forest Products

The third example illustrates how measures taken in Japan affect Canada's access to the U.S. market. The Japanese use tariffs to restrict sales of lumber and wood products in Japan by all North American producers, thereby increasing the demand for and price of unprocessed logs in world markets. Canada offsets the effects of the Japanese tariffs by controls on log exports that hold down log prices for lumber mills in British Columbia. Such controls do not exist in the United States; U.S. lumber producers, therefore, face higher log costs, which reduces their competitiveness relative to Canadian producers. Since export controls and some other differences in relative cost structures make Canadian lumber less costly to produce, Japanese lumber tariffs indirectly magnify Canadian-U.S. trade frictions over Canada's growing share of the U.S. softwood lumber market.

Major Influences on the Future of Canadian-Japanese Economic Relations

As the cases described in the previous section illustrate, each of the members of the triangular relationship can make policy choices that have unintentional effects on the others. When these interactions are negative, they can create obstacles to better economic relations among the members. This section examines two major policy developments — a reduction in the savings-investment imbalance between Japan and the United States and trade negotiations between Canada and the United States — that are likely to have a strong influence on the future of Canadian-Japanese economic relations.

Reduction in the U.S.-Japanese Savings-Investment Imbalance

Trade tensions between Japan and the United States will diminish as the imbalance between their savings-investment relationship is reduced. Since the early 1980s, Americans have invested more than they have saved. Savings have flowed into the United States from abroad to take advantage of relatively high U.S. real interest rates and the expected appreciation of the U.S. dollar. Higher exchange rates have made U.S. exports more expensive and many imports less expensive, thereby enlarging the U.S. current account deficit.

Japan, by contrast, has had a restrictive fiscal policy, savings in excess of domestic investment requirements, capital outflows, and a large current account surplus.

Balance can be restored if the two countries adopt complementary policy changes. The U.S. current account deficit must drop, as must Japan's trade surplus. On the U.S. side, this means either reducing the budget deficit or reducing private investment to bring demands on financial markets more in line with the supply of private savings. On the Japanese side, fiscal policy has to become less restrictive and domestic investment has to expand. If the two countries fail to adopt these complementary policy changes, the United States could see its trade deficit reduced by loss of confidence in U.S. economic policy, a drop in investment demand, and a recession.

Since mid-1985, the so-called Group-of-Five (G-5) major industrial countries, including the United States and Japan, have engaged in a coordinated policy approach to reduce the imbalance. Three elements are necessary to achieve this goal: U.S. deficit reduction, U.S. dollar depreciation, and stronger economic growth in Europe and Japan. Since the G-5's Plaza Agreement in September 1985, which coordinated central bank action to push down the U.S. dollar, dramatic depreciation has occurred, accompanied, of course, by dramatic appreciation of the yen. Still, the more fundamental changes in fiscal and monetary policies remain to be carried out. If those changes are undertaken in 1987, U.S. domestic growth could be expected to continue, while Japan's could be expected to increase. Canada would be a major beneficiary, since stronger performance among its trading partners would support the growth of Canadian exports.

The prospects for the fundamental policy changes required to restore balance are not good. In the United States, part of the Gramm-Rudman act, adopted in late 1985 to force deficit reduction, has been declared to be unconstitutional. In the absence of U.S. action, Japan and the other members of the G-5 have resisted stimulative policies. Close observers of Japanese policy are skeptical that Japan will rely soon on domestic

sources of growth to offset its dependence on export-led growth.[5] The reasons for this skepticism are founded on demonstrated Japanese policy and practice, which adhere to fiscal prudence and which emphasize exports rather than domestic demand as the engine of growth.

Canadian-Japanese economic relations, however, need to be viewed within the context of the longer term. A key assertion in this longer-term view is that the savings-investment imbalance will decline, either smoothly through close coordination of domestic macroeconomic policies or painfully and disruptively through recession and loss of confidence in U.S. economic policy. The latter course could be dramatic and sudden or drawn out and muddled. But the imbalance must decline, for the simple reason that massive U.S. foreign borrowing since the early 1980s has accumulated a huge foreign debt. This debt eventually will have to be serviced by running a surplus on trade in merchandise and traded services.

On the other side of the picture, Japanese savers have invested abroad, particularly in the United States. Since 1985, the strong yen has reduced the price attractiveness of Japanese exports, but it has also increased pressures on Japanese producers to invest abroad to maintain market share. These developments suggest that, eventually, Japan is likely to become a mature creditor nation — that is, one that takes in more earnings from its past foreign investments than it lays out in new investments.[6] When Japanese residents repatriate their foreign investment income, there will be upward pressure on the yen. The rise in the value of the yen then will open up a merchandise and traded services deficit, since a costlier yen will make it easier for cheaper foreign goods to compete against more expensive domestic products in the Japanese market. Factors other than price — product quality, for example — also will play a role, but the direction is clear: eventually, Japan may become one of the world's great markets for foreign exporters.

In early 1986, the Japanese government made public the Mayekawa Report, prepared by 17 distinguished former politicians and public servants and submitted to Prime Minister Nakasone.[7] Many of the report's recommendations, if implemented, could result in a more open Japanese market and stronger domestic demand. It suggests a series of policy measures that could transform Japan's economic structure during the next few years into one that is less dependent on export-led growth. The report

---

[5]See, for example, Masaru Yoshitomi, ***Japan as Capital Exporter and the World Economy*** (New York: Group of Thirty, 1985).

[6]Richard G. Lipsey and Murray G. Smith, ***Taking the Initiative: Canada's Trade Options in a Turbulent World***, Observation no. 27 (Toronto: C.D. Howe Institute, 1985), p. 12.

[7]Japan, Advisory Group on Economic Structural Adjustment for International Harmony, "Report," (the "Mayekawa Report"), submitted to the Prime Minister, Mr. Yasuhiro Nakasone, April 7, 1986 (Tokyo, 1986, Mimeographed).

suggests as guiding principles import expansion, more balanced growth, and greater reliance on market forces. Specific recommendations include:

- expanding domestic demand by stimulating housing construction, deregulating land use, stimulating consumption through personal income tax cuts and reduced work weeks, promoting social infrastructure investment, and abolishing tax exempt interest on savings;
- transforming Japan's industrial structure to allow for a more "harmonious" international division of labor by increasing coal imports, promoting direct investment abroad as well as accepting more foreign investment in Japan, and increasing agricultural imports;
- improving market access for imports;
- stabilizing exchange rates by eliminating major disparities in economic performance in the leading industrial countries and by internationalizing the yen; and
- promoting international cooperation.

The recommendation to speed the growth of domestic demand in Japan, if adopted, should gradually open up more opportunities for Canadians to export to that country. Greater Japanese interest in investing in Canada should also occur, since increased Japanese investment abroad will help to offset appreciation and its adverse effects on producers based in Japan.

Japan's emergence as a mature creditor nation will have profound consequences, but it is likely to be a long-term process. Of more immediate concern are the implications of the current Canadian-U.S. trade negotiations.

A Canadian-U.S. Trade Agreement

Canada exports between 25 and 30 percent of everything it produces, but apart from Australia, it is the only major industrial country that lacks an assured market of at least 100 million people. Canada has become increasingly dependent on the U.S. market while losing market share in the rest of the world, dropping to 3 percent in 1980 from more than 4 percent in 1970. Canada must respond to this economic challenge.[8] Since the late 1970s, an increasing number of Canadians have been investing and producing in the United States to gain access to the large U.S. market and to get around U.S. barriers to Canadian exports.

---

[8]Indeed, this was the theme of the *Report* of the Royal Commission on the Economic Union and Development Prospects for Canada (Macdonald Commission), submitted to the federal government in September 1985.

Canadians are now beginning to realize that if they are to maintain growth in living standards in the longer term, Canada's industrial structure must be rationalized so that high incomes can be generated by high-value-added activities. Since these adjustments are most likely to be achieved in an environment of growing rather then shrinking trade, Canada's policy options are few. One is to participate in a new round of multilateral negotiations under the General Agreement on Tariffs and Trade (GATT). Another is to hammer out bilateral agreements designed to secure access to large, high-income markets in such countries as the United States and Japan. A third option is to pursue bilateral and multilateral routes simultaneously.

In late 1985, the federal government chose to pursue the third of these alternatives — to be distinguished carefully from the so-called Third Option in Canadian foreign policy, which achieved prominence in the 1970s. This decision can be understood in the broader context of changes that occurred in Canada's economic position between 1970 and 1985. Favorable terms of trade in the early 1970s and reaction to the "Nixon shock" of 1971 — which sought to impose a 10 percent duty on all imports into the United States — generated political support in Canada for greater economic independence from the United States. Subsequent reversal of the terms of trade, exacerbated by the severity of the 1981–82 recession and by the slow recovery of Canada's traditional markets outside North America, led to increased policy emphasis on ensuring and augmenting market access.

In 1983, the federal government proposed that Canada and the United States negotiate a series of sectoral trade agreements that would enhance access to each other's markets.[9] This initiative fizzled because of lack of U.S. interest. By early 1985, it had become apparent to Canadians that rising protectionism in the U.S. Congress could isolate Canada in its small domestic market by reducing access to U.S. markets for key natural resources, services, and manufacturing industries. So Canada changed its proposal for bilateral trade negotiations. Instead of specific sectors being "on the table", the new initiative proposed discussing the elimination, with a few exceptions, of barriers in all sectors of economic activity.[10] While Prime Minister Mulroney described the proposal as a "comprehensive" negotiation, it would have to be sufficiently broad in its coverage to qualify under GATT Article XXIV as a free trade area agreement.

To some outside observers, this proposal flew in the face of the perceived traditional federal government objective of insulating the Canadian economy from the large U.S. economy. Some former Canadian

[9]See Canada, Department of External Affairs, *A Review of Canadian Trade Policy* (Ottawa, 1983).

[10]Prime Minister Mulroney, Statement to the House of Commons, September 26, 1985.

economic nationalists who had once supported such a policy thrust — including Donald S. Macdonald, former Minister of Finance and later Chairman of the Macdonald Royal Commission — later admitted, however, that once they had seriously studied Canada's economic predicament, they could see that there was no practical alternative to closer economic integration with the United States.[11] They and others argued in 1985 that Canada could risk its future political independence if it became economically isolated from the United States.[12] Explicit in these recommendations favoring the federal government's proposal was the recognition that comprehensive bilateral negotiations could be complementary to, or could even enhance, multilateral negotiations. The main problem with the multilateral approach was that, as late as mid-1985, there were few signs that a new GATT round would get under way and that, even if it did, there was no assurance that Canada's concerns would be addressed in the near future.

The negotiating objective in the bilateral talks is to establish a free trade area agreement that would allow both countries to pursue their own social, cultural, and immigration policies, and to make whatever trade arrangements they wish with third countries. The agreement could involve eliminating remaining tariffs between the two countries, finding ways to contain the future use of nontariff barriers, clarifying policies toward foreign investors, and creating a code governing future trade in services. The period of transition toward implementing the new agreement is expected to be an important issue for both sides.

If achieved, such an agreement could have important strategic dimensions for both countries. For Canada, more secure access to the large U.S. market implies better prospects for Canadian employment and investment. In turn, such improved prospects could ensure for Canada greater economic strength and more secure political independence. Certainly, given the current turbulence of the world economy, the status quo is no longer a viable option. Most Canadians, whether or not they agree with the choice of the bilateral option, are convinced that the threat of being isolated in the small Canadian market by an increasingly protectionist U.S. Congress must be dealt with by a change in trade policy. The bilateral route provides a practical means of encouraging Canadian manufacturers to meet the challenge by becoming more competitive, more aware of developments in the rest of the world, and, therefore, better able in future to export not only to the United States but to Japan and rapidly growing markets in other Asian countries and in Latin America.

---

[11]See Richard Gwyn, *The 49th Paradox: Canada in North America* (Toronto: McClelland & Stewart, 1985).
[12]See Lipsey and Smith, *Taking the Initiative*, pp. 89–102.

For its part, the United States, like Canada, sees the bilateral talks as part of a strategy to maintain an open world trading system. It views the prospect of achieving a trade-liberalizing agreement as both a symbol and a catalyst to attract other nations to the multilateral bargaining table. It also sees the bilateral talks as an opportunity to forge model agreements on the complex issues involved in traded services and investment that then could be applied more widely in multilateral talks.

Two important assumptions underlying these strategic objectives merit closer examination, namely:

- that access to the large U.S. market will increase the competitiveness of Canadian manufacturers; and
- that bilateral negotiations will serve as a catalyst to broader trade talks, including multilateral negotiations.

The first assumption is an important one in Canada's policy initiative and Canadian analysts have paid it considerable attention. Lipsey and Smith, for example, point out that sophisticated quantitative analyses find unequivocal gains for Canada from trade liberalization with the United States that range from 1.3 to more than 5 percent of Canadian GNP.[13] These results are based on simulations of the reallocation of employment and production out of industries in which Canada has a comparative disadvantage and into industries in which it has a comparative advantage; realization of economies of scale through specialization in fewer product lines for the large North American market; and cost reductions for consumers as high-cost, tariff-protected producers are phased out. Even so, these studies, as Lipsey and Smith point out, are unable to capture such dynamic effects of freer trade on growth and development as private-sector firms being forced to produce at world-competitive costs; capital and labor being encouraged to reallocate from potentially declining industries to potentially expanding ones; and Canadian firms being allowed to introduce new products and to participate early in emerging industries because of free access to high-income markets.[14]

The second assumption, that the bilateral talks can be a catalyst for broader talks, is also an important one. In part, it is based on the expectation that major new issues, such as services and investment, which have never before been included in trade negotiations, would be easier to define when only two parties with similar regulatory and legal systems are involved than would be the case among the more than 90 parties of the GATT. A Canadian-U.S. framework for agreement on these issues might

[13]Ibid., pp. 31–49.
[14]Ibid., p. 42.

then be applied in the multilateral forum. Of course, a breakdown of the bilateral talks would bode ill for the multilateral talks, but linkage of the two sets of talks can be a very positive development, as U.S. experts Aho and Aronson have pointed out.[15]

This assumption is also based on theoretical considerations of resource allocation. Many international observers have criticized bilateral free trade as potentially "trade diverting", or discriminatory against third countries. Trade diversion can occur when, for example, each country reduces tariffs on imports from the other. Products from third countries can then be diverted away from the North American market by products from Canadian or U.S. firms that are able to undersell their overseas competitors, not because they are the cheapest source of supply but because their tariff-free prices are lower than the tariff-burdened prices of imports from third countries. Trade diversion thus can provide mutual benefits to the two countries by giving their respective producers advantages over those from the rest of the world.

But "trade creation" also can occur. It can happen when, for example, Canadian firms find they can undersell their U.S. competitors in some lines while U.S. producers find they can undersell Canadians in other lines. As a result, specialization occurs and new trade develops. The European Community, in liberalizing trade among its members, has experienced such specialization, particularly on an intra-industry basis. To the extent that firms become more efficient producers in the enlarged market created by trade liberalization, they can be expected to be more competitive outside the free trade area as well. Third countries, however, should not expect greater automatic access to markets within the free trade area unless their producers create production facilities in one of the partner countries. Instead, they would have to gain concessions through the GATT multilateral bargaining process. This possibility, in relations between Canada and Japan, is examined below.

This summary of Canadian and U.S. negotiating objectives and examination of some of the key assumptions on which the talks are based illustrates some of the benefits to be gained and barriers to be overcome in achieving closer Canadian-U.S. economic integration. Whether or not the bilateral talks succeed, the debate about the initiative has had an irreversible catalytic effect on the Canadian private sector. It has encouraged Canadians to discuss their economic predicament and economic future; it has made many Canadians more aware of the opportunities afforded by more secure access to world markets.

---

[15]C. Michael Aho and Jonathan David Aronson, *Trade Talks: America Better Listen!* (New York: Council on Foreign Relations, 1986).

A Canadian-Japanese Free Trade Agreement?

Before concluding this discussion of trade strategies, one intriguing option — negotiating a free trade area between Canada and Japan — merits examination. The case for this option rests in large part on the relative sizes of Canada's existing trading relationships. Nearly 80 percent of Canada's exports go to the United States while 20 percent of U.S. exports go to Canada. Only 5 percent of Canada's exports go to Japan, however, and these are concentrated in primary products. Canada is not likely to give up chances of encouraging trade with Japan and other countries, nor should it concentrate exclusively on the U.S. market. But Canada's long-term trade policy goal of increasing the international competitiveness of its manufacturing sector is more likely to be achieved through access to its major trading partner than through expanded or more secure access to the Japanese market. Negotiating a free trade area with Japan would require sudden and major changes both in Canadian policies and in private-sector organization and management of a magnitude difficult to comprehend. Such an agreement would have to be phased in very slowly and would have to allow Canadians to increase their access to Japanese markets more quickly than the converse. Otherwise, Canadian firms could be swamped by successful Japanese exports.

Canada should increase its trade and investment relationship with Japan, but it should also secure greater access to the U.S. market. Closer integration of the Canadian and Japanese economies through expanded trade and investment and through negotiated GATT agreements could then follow.

Implications of a North American Trade Agreement for Canadian-Japanese Economic Relations

The changes under way in North American trade arrangements can be expected to create new challenges and opportunities in the triangular relationship. Canada's strategic goals in its negotiations with the United States — to ensure access to the large U.S. market and to increase the ability of Canadian manufacturers to trade more competitively in the rest of the world — can be expected to shape its view of future economic relations with Japan.

Canada seeks trade and investment opportunities to increase manufacturing competitiveness. Yet. the composition of Canadian exports to Japan is quite different from that of its exports to the United States, as Table 2 illustrates. In recent years, this difference has become more pronounced. The end products share of Canadian exports to the United States, for example, is increasing while that to Japan is stagnating. From Canada's perspective, the pattern of trade with Japan, its second largest trading partner,

Table 2
Commodity Composition of Canadian-U.S.-Japanese Trade Flows, 1975 and 1985
(percentage shares, by product)

Canadian-U.S. trade	Canadian exports to U.S.		U.S exports to Canada	
	1975	1985	1975	1985
Food, feed, beverages and tobacco[a]	4.3%	4.2%	5.6%	4.1%
Crude materials	24.8	13.0	6.1	4.5
Fabricated materials	31.0	31.8	17.1	17.1
End products	39.6	50.7	70.1	72.5
Not classified	0.3	0.3	1.1	1.7
Total (Can.$ millions)	*$21,074.0*	*90,623.0*	*23,616.3*	*74,484.6*
Canadian-Japanese trade	**Canadian exports to Japan**		**Japanese exports to Canada**	
	1975	1985	1975	1985
Food, feed, beverages and tobacco[a]	25.8	17.7	2.8	1.9
Crude materials	55.1	50.2	0.5	1.0
Fabricated materials	16.1	28.8	29.4	11.3
End products	3.1	3.3	66.8	85.4
Not classified	0.0	0.0	0.4	1.1
Total (Can.$ millions)	*$2,128.7*	*5,749.5*	*1,205.3*	*6,112.3*
U.S.-Japanese trade	**Japanese exports to U.S.**		**U.S. exports to Japan**	
	1975	1985	1975	1985
Primary products	1.5	0.6	22.7	19.6
Crude materials	0.3	0.2	40.6	25.7
Chemicals	2.6	2.1	9.6	13.7
Basic manufactures	23.8	10.3	4.0	5.9
Misc. manufactures	8.9	8.7	6.0	7.5
Machines, transport equipment	61.2	77.0	16.4	2.6
Not classified	1.7	1.0	0.5	2.6
Total (U.S.$ millions)	*$15,990.0*	*66,042.0*	*11,846.0*	*25,901.0*

[a]Includes live animals.

Sources: Statistics Canada, *Summary of External Trade*, Cat. no. 65-001, Tables M-1 and X-1, various issues; and United Nations, *Commodity Trade Statistics*.

would be more consistent with its economic goals if the product mix more closely resembled that of its trade with the United States.

Similarly, the bilateral talks can also be expected to shape Japan's view of its economic relations with North America — and particularly with Canada. One concern, voiced publicly by Prime Minister Nakasone, is that any Canadian-U.S. trade agreement not lead to trade diversion. Other concerns relate to the potential impact of liberalized trade arrangements on the Canadian-U.S. exchange rate and on the movement of capital and labor.

Trade Diversion and Creation

With respect to Japanese concerns about trade diversion, there are several reasons to conclude that a Canadian-U.S. trade agreement, in fact, could *create* triangular trade. This outcome could be accomplished in four ways. First, Japan conceivably could negotiate membership in the North American free trade area. Such a proposal is not new; a related idea was developed by Professor Kiyoshi Kojima in his 1971 proposal for a Pacific free trade area.[16]

Second, key elements of the Canadian-U.S. agreement could be offered to potential additional partners such as Japan. These elements, such as a code to cover traded services and guidelines for the treatment of foreign investment, are new issues that have not been the subject of earlier GATT negotiations. The bilateral agreement could be extended in subsequent GATT talks.

Third, triangular trade could be created through multilateral tariff negotiations. The Canadian-U.S. agreement, for example, could create tariff preferences for U.S. manufacturers competing in the Canadian market. A specific example can be found in the industrial machinery industry. After the tariff reductions established by the GATT Tokyo Round agreements take place in 1987, the Canadian tariff on industrial machinery will be 9.2 percent. The Canadian-U.S. trade negotiations might eliminate tariffs altogether for U.S. firms selling in Canada, which would give them a price advantage over, for example, their Japanese competitors, who would still be burdened by the tariff. Yet, if Japan were prepared to offer concessions to Canada that would increase access to the Japanese market for Canadian producers in another industry, for example, Canada might extend to Japanese producers the tariff reductions established in bilateral negotiations with the United States.

---

[16]Kiyoshi Kojima, *Japan and a Pacific Free Trade Area* (London: Macmillan, 1971).

Investment and Trade as Complementary Activities

The fourth route to trade creation lies through increased Japanese direct investment in Canada. The bilateral trade negotiations can be expected to create incentives to locate production facilities in Canada of sufficient scale to serve the entire North American market. These incentives could occur in several ways.

The first way would be through the prospect of Canadian-based producers obtaining secure access to the U.S. market and thereby benefiting from the relative cost advantages of producing in Canada rather than in the United States. In 1985, for example, the Japanese auto parts industry investigated the relative cost of producing in Canada. It concluded that while initial investment costs were likely to be higher in Canada than in the United States because of less certain government incentives and higher land costs, operating costs were likely to be lower in Canada because of lower labor costs, cheaper energy, and cheaper raw materials.[17]

The second way that incentives could occur would be provided by the establishment of rules of origin for third-country products. These rules would be negotiated to prevent third countries from shipping goods through one partner to the other's market. They would require, for example, that access through Canada to the U.S. market be allowed only if specified levels of value had been added to the product in Canada. It would be in the interest of Japanese producers, therefore, to invest in Canada and to add to the value of products they manufacture in Canada in order to comply with rules-of-origin criteria if they are to serve the North American market.

Canada's Policy Environment for Foreign Investment

Japanese and other observers have raised important questions about the potential impact of a bilateral trade-liberalizing agreement on major economic policy variables in Canada that could affect future investment decisions. This section first examines concerns about postagreement pressures on the Canadian-U.S. exchange rate and about the impact of an agreement on capital and labor flows. It then examines the potential impact of trade liberalization on the general policy climate for direct foreign investment in Canada.

[17]Pacific Automotive Co-operation, "Japanese Auto Parts Industry Interest in Canadian Investment Grows" (Toronto, August 1985, Mimeographed).

Policy Harmonization

Studies by Canadian economists[18] of the policy-harmonizing impact of a trade-liberalizing agreement on such major areas as exchange-rate policy emphasize two important general points. One is that any assessment of the likely postagreement pressures to harmonize the economic policies of Canada and the United States must distinguish such pressures from those already operating in the status quo. The second point is that certain areas of policy are unrelated to trade and, therefore, should not be included in the negotiations.

Both of these general points are applicable to an assessment of the impact of an agreement on monetary and exchange-rate policy. Each country follows its own monetary policy and allows its exchange rate to be determined largely by market forces. In this environment, Canada has long faced harmonization pressures because of the mobility of short-term capital flows. If Canada's monetary policy gets too far out of line with that of the United States, short-term capital flows responding to the resulting interest-rate differential affect the movement of the exchange rate. There is no reason, however, to believe that a trade agreement would seek to change the existing exchange-rate regime.

More relevant is the possibility that the exchange rate might come under transitory pressure during the agreement's implementation. This possibility has been examined in detail by Lipsey and Smith, who conclude that the impact of trade liberalization on the exchange rate is likely to be transitory, occurring only during the initial implementation phase of the agreement.[19]

The Impact on Capital and Labor

Another frequently raised concern is that without trade barriers, Canada might lose investment and employment to lower-cost production sites in the southern United States.[20] The relationship between direct foreign investment and a bilateral trade agreement is an important one meriting careful study. But in arriving at predictions about the future, an important assumption underlying the relationship must be examined, namely, that direct foreign investment and trade are substitutes. This assumption

---

[18]See, for example, C.D. Howe Institute, *Policy Harmonization: The Effects of a Canadian-American Free Trade Area* (Toronto, 1986).

[19]Ibid., pp. 33–34.

[20]These concerns are voiced by some Canadians. They have also been raised by Japanese analysts. Indeed, a Keidanren investment mission to the United States was enthusiastic in its reports on Louisiana, Texas, and Florida (although it found Oregon and Washington to be just as attractive). See Yoh Kurosawa, "Summary of Findings of Keidanren Investment Expansion Mission to the United States," *Keidanren Review* 99 (June 1986): 11.

certainly holds true when trade barriers exist. Canada's adoption of the National Policy tariff in 1879, for example, encouraged foreign investment in Canada to jump the tariff wall. As the tariff wall has diminished with the phase-in of Tokyo Round tariff cuts, it seems reasonable to assume that some investment may have departed and new investment may have been lured to the United States by lower-cost labor and by close proximity to the large U.S. market.

This assumption, however, overlooks a number of important determinants of direct foreign investment decisionmaking. In a study of these determinants, Professor A.E. Safarian, a well-known Canadian specialist on the subject, points out good reasons for assuming investment is no longer primarily a substitute for trade.[21] These include factors influencing the investment decisions of multinational enterprises, such as the use of subsidiaries and licensing to go abroad and the opportunities for specialization in low-cost product lines that would be afforded by access to a larger market. Evidence from European experience with trade liberalization indicates that while firms do not depart *en masse*, high-cost, inefficient operations dependent on protection do close down. What follows is intracorporate and intra-industry trade with specialization increasing at the product level.

Safarian points out that the general experience of established free trade areas and the international economy suggests an assumption that is more appropriate to the late 1980s, namely, that trade primarily complements investment; the two expand together. He notes that in the European Economic Community (EEC), "the disappearance of internal tariffs and the growth of the EEC market spurred a good deal of investment...by U.S. firms....[D]irect investment by EEC multinationals themselves also expanded rapidly within the common market."[22]

Safarian concludes that Canada's ability to maintain a favorable investment policy and to handle the adjustment burden arising from a trade agreement with the United States is a more important determinant of how well the agreement will work than is the disappearance of trade barriers.

In summary, the weight of existing evidence suggests that the major factors in a Canadian-U.S. agreement that could encourage Japanese investment in Canada are those that relate to assured Japanese access to the entire North American market and to Canada's overall policy environment, rather than to the exchange rate or to factor movements *per se*.

---

[21]A.E. Safarian, "The Relationship Between Trade Agreements and International Direct Investment," in Ontario Economic Council, *Canadian Trade at a Crossroads: Options for New International Agreements* (Toronto, 1985), p. 206.
[22]Ibid., p. 213.

Canada's Investment Climate

In 1982, a high-level Japanese Survey Mission on the Overseas Investment Climate of Canada identified numerous policy-related obstacles to Japanese investment in Canada. Those most frequently cited included the National Energy Program (NEP), the Foreign Investment Review Agency (FIRA), federal-provincial jurisdictional conflicts, and industry-specific bureaucratic controls and ownership regulations. Another frequently cited obstacle, not considered to be policy related, was the relatively small size of the Canadian market.

During the early 1980s, Canada's investment policy strategy was based on natural resource megaprojects, which themselves were based on the assumption that world prices for Canada's abundant natural resources would go on rising through the 1980s. The NEP, introduced in 1980, discouraged foreign investment by imposing restrictions on energy exports and on foreign ownership of any energy projects within federal jurisdiction. The federal government used FIRA in the early 1980s to ensure that foreign investors demonstrate that their projects would result in "significant benefit to Canada." Foreign investors complained that FIRA's criteria for screening investments were not clearly defined, that the duration of the screening process was too long, and that it called for unreasonable undertakings.

The decline in natural resource prices in world markets and growing dissatisfaction with the NEP and FIRA brought about the demise of the resource megaproject investment strategy.

The economic strategy that the federal government has pursued since 1984 is more broadly based and seeks to improve the climate for investment and growth in all sectors — resources, manufacturing, and services. Major elements of the strategy include reduction of the federal budget deficit, adoption of a more welcoming attitude toward foreign investment, increased reliance on market forces in the energy sector, and negotiation of a comprehensive bilateral trade agreement with the United States to secure and enhance Canada's access to its largest export market.

By replacing FIRA with Investment Canada, the federal government intended to send an important signal to foreign investors, namely, that Canada now would encourage foreign investment instead of screening and restricting it. As a result of these changes, the number of proposals subject to investment review has declined significantly. Indeed, of the 35 Japanese investment projects registered with Investment Canada from July 1985 to June 1986, only 4 were reviewed and they were quickly approved.

A reasonable question may remain in the minds of some Japanese investors, however, as to whether the recent change in the federal

government's investment review procedures is permanent or temporary. The opposition Liberal party, for example, continues to place considerable emphasis on screening foreign investment and limiting foreign ownership in the Canadian economy. A change of government at the federal level, therefore, could see a return to investment policies of the past.

The dismantling of the NEP was also intended to signal foreign investors that Canada would rely more on market forces and less on government incentives and regulations to determine the pattern of investment in Canada's energy sector. As with the changes to FIRA, however, foreign investors may question the permanence of Canada's new energy policy. The political pressures and nationalism demonstrated during the period of rising prices and supply shortages in the 1970s inevitably will weigh heavily on the minds of foreign investors considering long-term strategies. Canadians will have to come to terms with their tendency to welcome foreign investment when times are difficult and to become hostile toward it when world commodity markets boom. Ownership and control issues are likely to be less sensitive with Japanese investors if their demonstrated tendency to take minority equity positions continues.[23]

By 1986, Japanese attitudes toward investing in Canada had improved significantly, as indicated by the report of the Kanao mission on the climate for investment in Canada.[24] The report stated that the mission had found "a new Canada." It saw improvements in federal and provincial investment promotion programs, a better labor relations climate, and increased emphasis on high-technology industries as being responsible for this improved climate. Participants in the mission indicated concern, however, about the possible impact of a Canadian-U.S. trade agreement on existing and planned Japanese investment in Canada.

Another sector that has seen changes in Canadian policy is financial services. As international capital markets have grown and become global in nature, Canada has been forced to relax foreign ownership limits to ensure the continued growth and competitiveness of its financial sector. Recent changes have raised the asset ceiling for foreign-owned banks to 16 percent of the total domestic assets of the Canadian banking system. Proposals also have been made to increase the limit on foreign ownership of securities firms. These changes represent a significant opportunity for foreign, including Japanese, financial institutions to increase the scale of their operations in Canada.

Changes have also occurred in the auto industry, and recent announcements of significant Japanese investment decisions signal increased

---

[23]Richard W. Wright, *Japanese Business in Canada: The Elusive Alliance* (Montreal: Institute for Research on Public Policy, 1984).

[24]Japanese Economic Mission to Canada 1986, *Discovery of a "New Canada"* (Tokyo, 1987).

Japanese interest in investing in Canada. There are, however, special considerations in the auto industry. Canada followed the lead of the United States and sought a Japanese VER agreement on autos in 1982. Although the quantitative restraint on Japanese auto imports has been relaxed, it has not been withdrawn entirely. The Canadian government's strategy has been to link relaxation of the VER to increased Japanese investment in automobile assembly and parts production in Canada. Thus, Japanese auto firms are investing in Canada partly to maintain their share of the Canadian market.

North American auto producers have reacted to increased Japanese investment in Canada and the United States by arguing that the new plants raise the prospect of considerable excess capacity developing in the industry by the late 1980s. This prospect has placed new pressures on the Japanese. Under the Canadian-U.S. auto pact, producers in Canada can obtain duty-free access to the U.S. market if they meet certain North American content requirements and certain production levels in Canada. Since auto producers currently participate in the auto pact on a voluntary basis, North American producers now argue that nonmembers have an unfair advantage because they do not have to meet North American content requirements. North American producers propose that all firms selling in North America be required to meet auto pact content and production requirements. Japanese auto producers, however, view the current system as fair, because it offers duty-free trade between the United States and Canada if auto pact conditions are met, while allowing foreign firms that do not meet the conditions access to either market if they pay the required duty. As global trade in automobiles becomes increasingly "managed", it is not inconceivable that Canada and the United States could invoke mandatory content requirements that would force Japanese producers to increase parts production in North America. This is not, however, the current intent of the Canadian and U.S. negotiators attempting to work out a new trade agreement.

Another pressure on Japanese and other foreign producers is the claim by U.S. auto producers that Canada's duty remission scheme for automotive parts constitutes an export subsidy and, consequently, should be subject to U.S. countervailing duties. Under the current system, Canada's duty remission scheme has been an important instrument for inducing foreign producers to locate in Canada. Firms in Canada that export automobiles or parts qualify automatically for a reduction in the dutiable value of the autos or parts they import by 70 to 100 percent of the value of their exports. This duty remission can be interpreted to be a subsidy to exports. Honda cars, for example, shipped into Canada qualify the company for duty remission on imports with a value equal to the Canadian value added contained in exports from Honda's Canadian operation.

Michigan and other U.S. auto-producing states strongly oppose Canada's duty remission scheme as an unfair and distortionary inducement to locate investment in Canada and they argue that the scheme should be subject to countervailing duties. Japanese firms currently setting up production facilities in Canada are unlikely, under present circumstances, to obtain a Canadian-U.S. agreement similar to that obtained for Volkswagen in the late 1970s, which permitted that company to earn duty remission on exports to the United States without being concerned about countervail.

One way that Japanese auto producers could avoid these problems would be to meet the requirements of the auto pact. It has been announced, for example, that the General Motors-Suzuki joint venture in Ontario intends to meet the 60 percent Canadian content requirement, meaning that important components such as chassis, engines, and body parts will have to be manufactured in Canada.

In summary, Canada's investment climate in the late 1980s is being influenced by two factors. The first is policy changes that encourage foreign investment, as illustrated by the examples of the NEP, FIRA, and the financial sector. The second is the increasing degree to which trade is being "managed", as illustrated by developments in the auto industry, to relieve the excess capacity building up in North America. Trade pressures can be expected to influence Canada's future investment policies toward industries experiencing managed trade.

Conclusion

Many factors are likely to influence the future of the Canadian-Japanese "leg" of the Canadian-U.S.-Japanese economic triangle. One of the most important of these will be Japan's response to the realignment that is occurring between the U.S. and Japanese currencies. Part of that response will be to locate production facilities abroad to maintain market share. Eventually, the growth of Japanese domestic demand may increase. Inexorably, however, Japan's current emphasis on investing its huge domestic savings abroad will result in a growing surplus of foreign interest and dividend income that will encourage it to become a major importer of foreign goods and services. This trend will create opportunities for Canadians to encourage Japanese investment and to seek Japanese markets. But the process will be slow.

The other major factor that will affect the future of Canadian-Japanese economic relations is a comprehensive agreement between Canada and the United States. More assured Canadian access to the U.S. market, combined with a more welcoming investment climate in Canada, can lead to increased bilateral ties. The risk exists, however, that the bilateral agreement will divert rather than create trade. It may be possible, during

subsequent multilateral negotiations, to persuade Japan to make concessions that would allow it access to provisions of the North American agreement. There is, however, no automatic way for Japan to benefit from the bilateral trade agreement other than through investing in North American production facilities. For this reason, the climate for foreign investment in Canada will be an important determinant of future economic integration.

Future research should continue to monitor factors influencing Japanese economic activity. But the next major step should be to examine the complex subject of how Canadians can penetrate the Japanese economy with trade and investment activities.

Strengthening the economic relationship between Japan and Canada will require deliberate policy changes and actions by government and the private sector in both countries. If the will to change exists, however, the trade and investment opportunities are there to be developed.

Appendix

Table A-1
Bilateral Merchandise Trade Flows, Canada, Japan, and the United States, 1971–85
(as a percentage of bilateral GDP)

	Canada-U.S.	Canada-Japan	U.S.-Japan
1971	1.9	n.a.	0.9
1972	2.1	n.a.	1.0
1973	2.3	0.5	1.1
1974	2.8	0.6	1.2
1975	2.6	0.5	1.0
1976	2.7	0.5	1.1
1977	2.7	0.4	1.1
1978	2.7	0.4	1.2
1979	2.9	0.4	1.3
1980	2.9	0.5	1.4
1981	2.8	0.5	1.5
1982	2.6	0.5	1.4
1983	2.7	0.5	1.5
1984	2.9	0.5	1.7
1985	2.9	0.5	1.7

Sources: Statistics Canada, *Quarterly Estimates of the Canadian Balance of International Payments*, Cat. no. 67-001, various issues; International Monetary Fund, *International Financial Statistics Yearbook, 1986* (Washington, D.C., 1986), p. 257; Organisation for Economic Co-operation and Development, *Main Economic Indicators*, various issues; United States, Department of Commerce, *Survey of Current Business*, various issues.

Table A-2
Bilateral Merchandise Exports, Canada, Japan, and the United States, 1971–85
(as a percentage of exporting country's GDP)

	Canadian-U.S. trade		Canadian-Japanese trade		U.S.-Japanese trade	
	Canadian exports	U.S. exports	Canadian exports	Japanese exports	U.S. exports	Japanese exports
1971	12.8	1.0	n.a.	n.a.	0.4	3.2
1972	13.4	1.1	n.a.	n.a.	0.4	3.1
1973	14.0	1.2	1.4	0.2	0.6	2.4
1974	14.8	1.5	1.5	0.3	0.8	2.7
1975	13.5	1.5	1.3	0.2	0.6	2.3
1976	13.3	1.5	1.2	0.3	0.6	2.8
1977	14.6	1.5	1.1	0.2	0.6	2.7
1978	16.0	1.4	1.2	0.2	0.6	2.5
1979	16.8	1.6	1.5	0.2	0.7	2.6
1980	16.2	1.6	1.4	0.2	0.8	3.0
1981	16.2	1.5	1.3	0.3	0.7	3.3
1982	15.8	1.3	1.2	0.3	0.7	3.5
1983	16.7	1.3	1.2	0.3	0.7	3.6
1984	19.8	1.4	1.3	0.3	0.6	4.8
1985	20.3	1.4	1.2	0.3	0.6	5.0

Sources: Statistics Canada, *Quarterly Estimates of the Canadian Balance of International Payments*, Cat. no. 67-001, various issues; International Monetary Fund, *International Financial Statistics Yearbook, 1986* (Washington, D.C., 1986), p. 257; Organisation for Economic Co-operation and Development, *Main Economic Indicators*, various issues; United States, Department of Commerce, *Survey of Current Business*, various issues.

Table A-3
Bilateral Merchandise Imports, Canada, Japan, and the United States, 1971–85
(as a percentage of importing country's GDP)

	Canadian-U.S. trade		Canadian-Japanese trade		U.S.-Japanese trade	
	Canadian imports	U.S. imports	Canadian imports	Japanese imports	U.S. imports	Japanese imports
1971	11.3	1.1	n.a.	n.a.	0.7	1.8
1972	12.0	1.2	n.a.	n.a.	0.8	1.7
1973	13.0	1.3	0.8	0.4	0.7	2.0
1974	14.2	1.6	1.0	0.5	0.9	2.4
1975	14.2	1.4	0.7	0.4	0.7	2.0
1976	13.0	1.5	0.8	0.4	0.9	1.8
1977	13.9	1.5	0.8	0.3	1.0	1.5
1978	14.9	1.6	1.0	0.3	1.2	1.3
1979	16.6	1.6	0.8	0.3	1.1	1.8
1980	15.8	1.6	0.9	0.4	1.2	2.0
1981	15.1	1.6	1.2	0.3	1.3	1.9
1982	12.8	1.6	1.0	0.3	1.2	1.9
1983	13.2	1.7	1.1	0.3	1.3	1.8
1984	15.2	1.8	1.3	0.3	1.7	1.9
1985	15.9	1.8	1.3	0.3	1.7	1.7

Sources: Statistics Canada, *Quarterly Estimates of the Canadian Balance of International Payments*, Cat. no. 67-001, various issues; International Monetary Fund, *International Financial Statistics Yearbook, 1986* (Washington, D.C., 1986), p. 257; Organisation for Economic Co-operation and Development, *Main Economic Indicators*, various issues; United States, Department of Commerce, *Survey of Current Business*, various issues.

A Japanese Perspective[1]

Hideo Sato

Japan is the world's second-largest market economy after the United States. Canada has a much smaller economy but, as one of the seven most important industrial nations, it is still a major actor in the international economic system. Japan is Canada's second-largest trading partner, while Canada ranks ninth among Japan's trading partners. Consequently, the Canadian-Japanese economic relationship is important in itself and deserves serious attention. In analyzing this relationship between the two countries, one could treat it as a kind of "dyad" by focusing on their individual characteristics and on the pattern of their past interactions without paying attention to any other international interaction. Such a "dyadic interaction" approach often explains much of the variation in the two countries' behavior; indeed, virtually all existing studies on Canadian-Japanese economic relations implicitly adopt this approach.[2]

Both countries, however, have major economic and political ties with the United States. Thus, any analysis of the Canadian-Japanese relationship that is unmindful of the role of the United States may constrain substantially our understanding of the nature of that relationship. As one observer has noted, "For both countries, the United States — like it or not — is the most important political and economic partner. Consequently, the U.S. factor is considered primary by both countries and decisions made by one or the other are often viewed through the U.S. lens."[3]

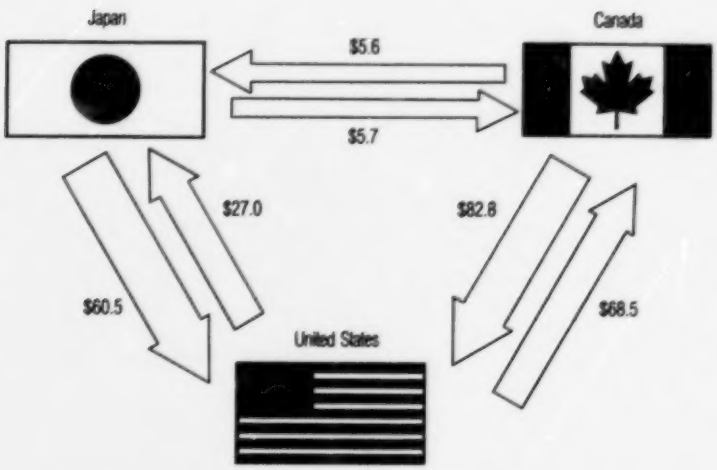
This "triangular" relationship is particularly meaningful in a multipolar world in which the United States no longer has undisputed hegemony. Like Great Britain in the nineteenth century, the United States in the postwar era played a preponderant role in the creation and maintenance of a free trade regime. Since the late 1960s, this authority has declined;

[1]This study has been made possible by the Canada-Japan Research Award of 1985 from the Department of External Affairs, Government of Canada. The author wishes to acknowledge valuable comments and suggestions by Dr. Wendy Dobson and Professor Frank Langdon on an earlier version of this paper.

[2]See, for example, Klaus H. Pringsheim, ***Neighbors Across the Pacific: Canadian-Japanese Relations 1870–1982*** (Oakville, Ont.: Mosaic Press, 1983); Frank Langdon, ***The Politics of Canadian-Japanese Economic Relations, 1952–1983*** (Vancouver: University of British Columbia Press, 1983); and Keith A.J. Hay, ed., ***Canadian Perspectives on Economic Relations with Japan*** (Montreal: Institute for Research on Public Policy, 1980).

[3]Michael W. Chinworth, "Japan-Canada Relations," ***JEI Report*** (Washington, D.C., Japan Economic Institute), No. 30A, August 9, 1985, p. 8.

Figure 1
Trade Flows Among Canada, Japan, and the United States, 1984
(Can.$ billions)



Source: Wendy Dobson, "Canada, Japan, the United States, and the Triangular Economy" (Backgroud paper prepared for the Canada-Japan Business Co-operation Committee, Nagoya, May 19, 1986), pp. 22 – 23.

the United States gradually has lost the power to sacrifice short-term national interests for the systemic objective of maintaining a free trade regime by itself. At the same time, the relaxation of Cold War tensions has reduced the United States' incentive to make short-term sacrifices for the sake of the "free world".[4] In short, the United States has now become much more sensitive to its interdependence with its postwar allies, including its two largest trading partners, Canada and Japan.

Yet U.S. primacy in the two countries' foreign relations is undisputed and suggests that any examination of Canadian-Japanese relations should be a function of relations both have with the United States. The trade flows in Figure 1 illustrate the magnitude of the triangular economic relationship. The purpose of this study is to examine Canadian-Japanese economic relations in the context of political relations between the two countries.

---

[4]Hideo Sato, "The Political Dynamics of U.S.-Japan Economic Conflicts," *Journal of Northeast Asian Studies* 3 (Spring 1984): 5–7.

Three strands of Canadian foreign policy make up this context: Canada's historical interest in the so-called Third Option, its perceived tendency to ride on the coattails of the United States, and its tendency to rely on a special political relationship with the United States.

Japan as Canada's "Third Option"

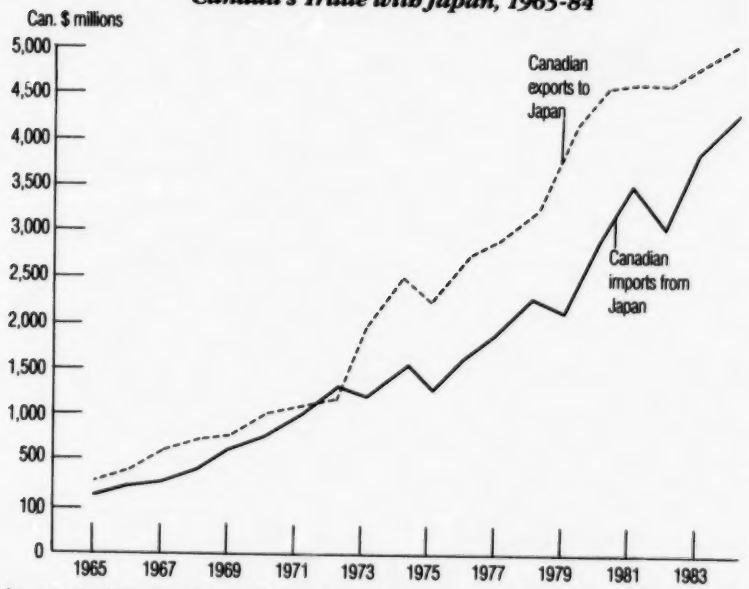
Canada has long maintained a somewhat ambivalent attitude toward the United States. On the one hand, it has sought to capitalize on its close historical, cultural, and economic relationship with its giant neighbor. On the other hand, it has sometimes tried to preserve its cultural and economic autonomy by diversifying economic relations to reduce excessive reliance on the United States. The latter type of foreign policy posture, favored by the Trudeau government after it came to power in 1968, became known as the Third Option — the First Option consisting of maintaining the status quo with the United States and the Second Option consisting of closer integration with it. Canadian articulation of its Third Option coincided with the pronouncement in the United States of the Nixon Doctrine, itself a manifestation of the United States' desire to lessen its foreign policy burdens as its hegemonic position became increasingly undermined.

It was as part of the Third Option that Canada took greater notice of the Pacific area in general and Japan in particular. Canada consciously sought to expand trade and investment relations with Japan during the Trudeau years. An opportunity for Canada to put substance into the Third Option policy appeared in the wake of the Nixon administration's decision in 1971 to impose a 10 percent surcharge on imports and to take the United States off the gold standard. As a result of this "Nixon shock", Japanese government officials and leaders feared that Japan might lose an important share of its North American market unless it opened its own market to foreign imports. Consequently, Japan made an unusual effort in 1972 to sell Canadian manufactured goods in Japan, even though these goods competed directly with Japanese products.

It was clearly in Canada's interest to seize this opportunity to market its manufactured products in Japan to correct what was seen as an "undesirable" structure of trade between the two countries. Canadian exports to Japan had consisted mainly of raw materials and agricultural products, whereas imports from Japan had been almost exclusively manufactured products. As far as Canadians were concerned, this qualitative trade imbalance had left Canada "in a position of a less-developed country in relation to Japan."[5] What was worse, manufactured imports from Japan

[5]Richard W. Wright, *Japanese Business in Canada: The Elusive Alliance* (Montreal: Institute for Research on Public Policy, 1984), p. xvi.

Figure 2
Canada's Trade with Japan, 1965-84



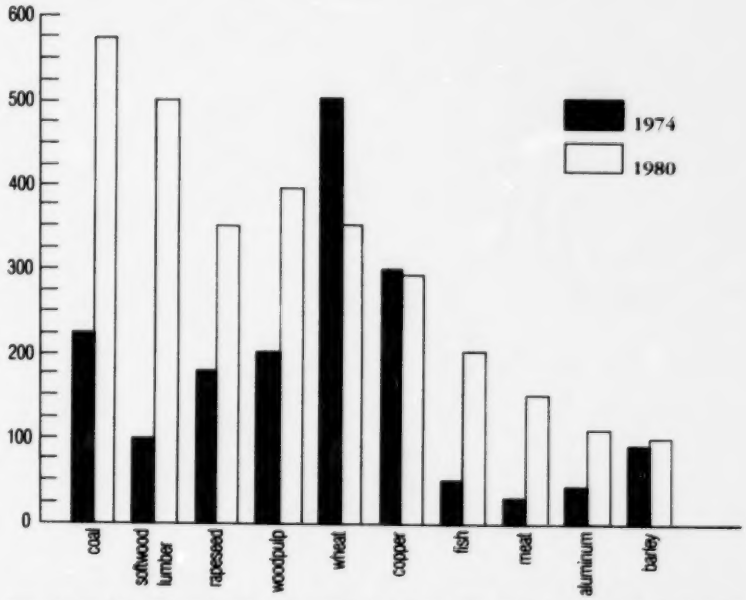
Sources: Statistics Canada; and the Japan Tariff Association. The figures after 1981 are based on Japanese statistics.

had tended to concentrate in Quebec and Ontario, where competing products were manufactured. In Western Canada — and in British Columbia and Alberta in particular — the situation was quite different. These provinces had benefited directly from large exports of raw materials and agricultural products to Japan. As a result, a serious conflict of interest existed between Western and Central Canada over Japanese trade. The Canadian federal and provincial governments sent various sales missions to Japan in attempts to increase manufactured exports to that country, but these missions did not bear much fruit. Canadian businessmen largely failed to follow up with initiatives of their own, and those who did were importers of Japanese products who had frequently visited that country without any Canadian or Japanese government assistance.[6]

As Figure 2 shows, Canadian exports to Japan increased steadily after 1972, creating a substantial trade surplus that persisted until recently.

[6]Langdon, *The Politics of Canadian-Japanese Economic Relations*, p. 76.

Figure 3
Major Canadian Exports to Japan, 1974 and 1980

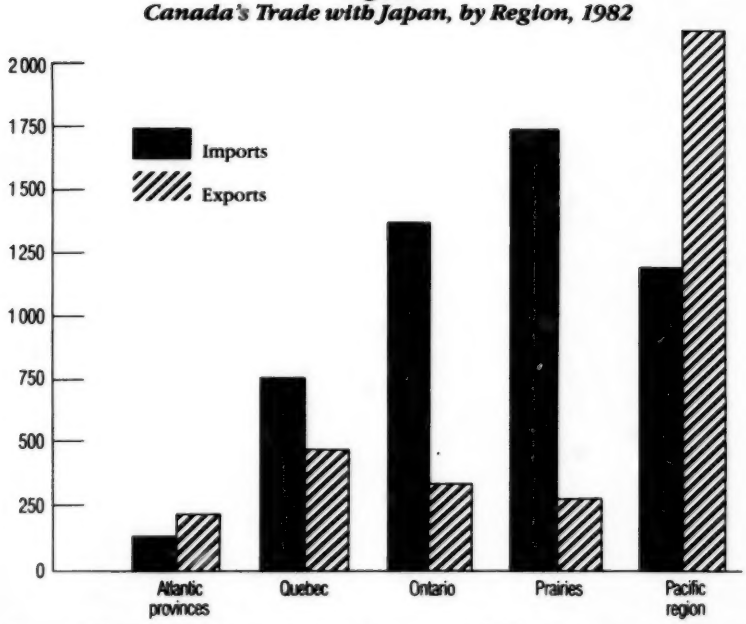


Sources: K.A.J. Hay and S.R. Hill, *Canada-Japan: The Export-Import Picture 1975* (Ottawa: Canada-Japan Trade Council, 1976), p. 10; and idem, "Canada-Japan Trade Statistics," *Canada-Japan Trade Council Newsletter*, March 1981, p. 5. This particular figure was prepared by Robert Blain for his M.A. thesis at York University, Toronto.

It should be noted, however, that the exports which increased most rapidly were such raw materials and agricultural products as coal, lumber, rapeseed, and woodpulp, as is evident in Figure 3. In other words, Western Canada benefited from increased exports to Japan while Ontario and Quebec continued to suffer from serious trade deficits (see Figure 4). The share of Canadian finished manufactured products (or end products) in total Canadian exports to Japan hovered around the 2–4 percent range, in marked contrast to the structure of its trade with the United States, where the share of end products was as high as 34 percent in 1981 (see Figure 5).

It is of no consolation to Canada that the United States has had the same kind of problem in its trade with Japan. As shown in Table 1, more than 60 percent of U.S. exports to Japan consist of industrial supplies — such as coal, logs and lumber, raw cotton, and hides and skins — and

Figure 4
Canada's Trade with Japan, by Region, 1982



Source: *Kokusai Keizai* (Tokyo), No. 256, December 15, 1984, p. 72. Based on data from Statistics Canada.

agricultural products, while more than 65 percent of U.S. imports from Japan consist of automotive products and capital goods (machinery and transportation equipment). The United States, too, has long complained about this situation. As a U.S. congressional report stated a few years ago, "we are a developing nation supplying a more advanced nation — we are Japan's plantation: haulers of wood and growers of crops, in exchange for high technology, value-added products....[T]his relationship is unacceptable."[7] Consequently, the United States has been anxious to increase its manufactured exports to Japan.

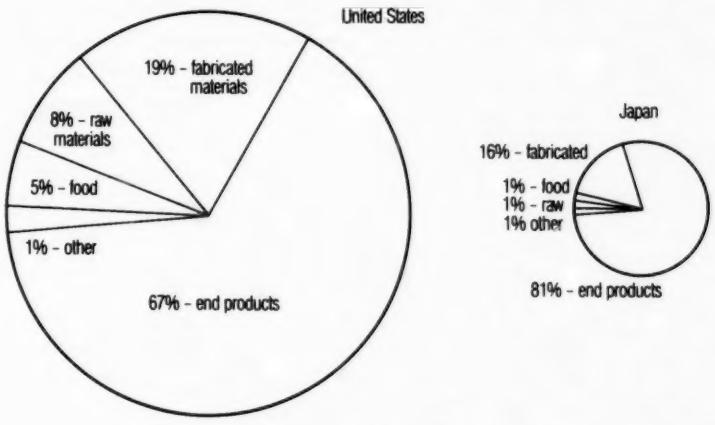
One major obstacle to increased Canadian exports of manufactured goods to Japan is the fact that several Canadian industrial sectors that could export competitively to Japan are dominated by subsidiaries of U.S. firms.

---

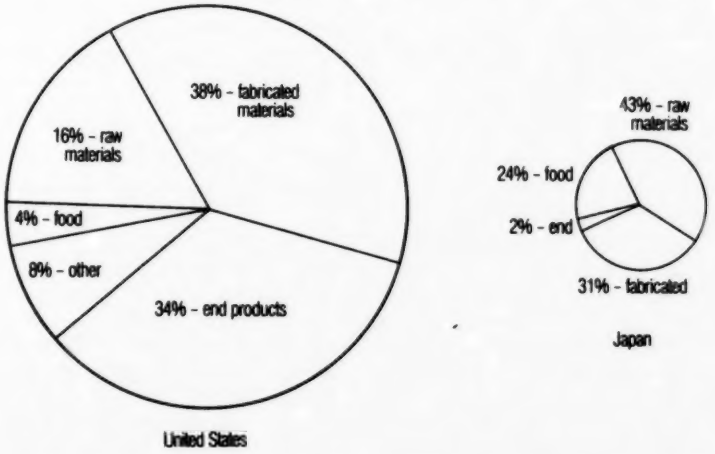
[7]United States, Congress, House of Representatives, Subcommittee on Trade of the Committee on Ways and Means, *United States-Japan Trade Report* (Washington, D.C.: U.S. Government Printing Office, September 5, 1980), p. 5.

Figure 5
Composition of Canadian Trade with Japan and the United States, 1981

(A) Imports from Japan and the United States



(B) Exports to Japan and the United States



Source: Richard W. Wright, ***Japanese Business in Canada: The Elusive Alliance*** (Montreal: Institute for Research on Public Policy, 1984), p. 16.

Table 1
U.S. Trade with Japan, 1985

	U.S.$ millions	Percentage
U.S. exports to Japan[a]		
Industrial supplies	$8,679.9	38.4%
Capital goods	5,938.6	26.2
Food and feed	5,000.7	22.1
Consumer goods	1,415.5	6.3
Other	1,596.1	7.0
Total exports	*22,630.8*	*100.0*
U.S. imports from Japan[b]		
Automotive products	24,980.0	36.3
Capital goods	21,515.7	31.3
Consumer goods	14,017.2	20.4
Intermediate goods	7,035.3	10.2
Other	1,234.7	1.8
Total imports	*68,782.9*	*100.0*

[a]F.a.s value basis.

[b]Customs value basis.

Source: *JEI Report* (Washington, D.C., Japan Economic Institute), no. 19A, May 16, 1986, and no. 24, June 27, 1987.

When spotting a prospective sale in Japan, the U.S. parent company tends to shift the order to the United States, racking up a credit for that country instead of for Canada.[8] But even Canadian companies that are not dominated by U.S. capital and are not U.S. subsidiaries do not seem to compete well against U.S. rivals for Japanese markets. Canadian Ambassador to Japan, Barry Steers, in attempting to explain this phenomenon, has observed, "The problem with the 'third option' was that Japan's most important relationship was with Washington."[9]

As an example of how this process has worked, Canada has been trying to sell its CANDU heavy water nuclear reactor to Japanese utilities for many years, but has had no success because Japan uses U.S. made light water reactors. Similarly, Canada has tried to persuade Japan Air Lines and other Japanese companies to purchase the Canadian-made Dash short-to-medium range commercial airliner, but the Japanese have favored U.S. aircraft.[10] A notable exception to this trend may be the Japanese decision in 1985 to place an order worth U.S.$250 millions for telecommunications equipment with Northern Telecom, a subsidiary of Canadian-owned

[8]Chinworth, "Japan-Canada Relations," p. 7.
[9]David Stewart-Patterson, "Japan nervous over Canada's moves toward U.S.," *Globe and Mail* (Toronto), December 10, 1984, p. R3.
[10]Chinworth, "Japan-Canada Relations," p. 7.

Bell Canada Enterprises Inc. The purchaser, Japan's NTT (Nippon Telephone and Telegraph Co.) settled on Northern Telecom after looking at open bids from that company, U.S. giant AT&T, and four Japanese companies. In the United States, though, it was emphasized that Northern Telecom is also a U.S. company, with headquarters in Nashville, Tennessee, and that the switching systems for NTT would be produced at a plant near Raleigh, North Carolina.[11]

In the final analysis, Canada's attempt to increase manufactured exports to Japan as part of the Third Option has not produced any spectacular results. Moreover, Canada's trade surplus with Japan, once as high as Can.$1.8 billion, shrank during the 1970s and early 1980s because Japanese demand for Canadian raw materials slowed down and because Canadian imports of Japanese value-added manufactured products, including automobiles and parts, telecommunications equipment, and electronics, increased dramatically. By 1984, Canada had a trade deficit with Japan of Can.$82 million, which increased to between Can.$100 and $200 million in 1985.[12]

Canada has also tried to induce direct Japanese investment, particularly in manufacturing. Indeed, the amount of annual investment did increase to Can.$500 million in 1979 from Can.$194 million in 1972. But the amount of cumulative investment is not particularly large. In 1985, just Can.$1.6 billion of Japan's total overseas direct investment was located in Canada, a fraction of the Can.$19.9 billion invested in the United States and well behind the Can.$3.2 billion directed to Australia, a country with similar political and economic concerns toward Japan to those of Canada.[13]

Not only is Japanese investment in Canada limited, but it is heavily concentrated in resource development, much to the chagrin of Canadian policymakers who have been severely critical of decisions to put money into such areas as coal mining and tar sands development at the expense of job-creating investments in manufacturing. There are, of course, a few important exceptions, including Mitsubishi Electric's television tube plant in Midland, Ontario; Honda's investment in the auto assembly plant in Alliston, Ontario, and Toyota's investment in the aluminum wheel plant in Delta, B.C., and its recent decision to build an auto assembly plant in

---

[11]Interview with NTT officials, San Francisco, March 13, 1986; and Edmund B. Fitzgerald, Chairman, Northern Telecom Inc., Statement before the U.S. Senate Finance Committee, Subcommittee on International Trade, Washington, D.C., May 3, 1985, pp. 15–17.

[12]Ann Walmsley, "Canada's Tense Trade Ties with Tokyo," *Maclean's* April 22, 1985, p. 35; and Brian Milner, "Yen's rise cited as reason to end Japanese car import restrictions," *Globe and Mail* (Toronto), February 21, 1986, p. B4.

[13]Chinworth, "Japan-Canada Relations," p. 4.

Cambridge, Ontario; and Suzuki's recent decision to build an auto assembly plant in Ingersoll, Ontario, in a joint venture with General Motors.

One of the bottlenecks for Japanese investment in Canada was the disposition of the Foreign Investment Review Agency (FIRA). The agency was designed to encourage foreign investment while preserving Canadian policy objectives of fostering economically desirable projects, such as manufacturing and additional processing of mineral resources. But FIRA came to be perceived as a political bureaucracy shrouded in red tape and hostile toward potential investors. Japanese business interests saw the Trudeau government itself, especially in its later years, as unstable and unnecessarily combative, particularly toward the United States. Such a perception also might have acted as an impediment to Japanese investment in Canada.[14] Under the Progressive Conservative government led by Brian Mulroney, FIRA has been reorganized and renamed "Investment Canada", promising greater assistance to potential investors with fewer strings attached. While apparently retaining the spirit of the Third Option, the Mulroney government seems eager to improve relations with the United States. Consequently, more Japanese investment in Canada and more trade between the two countries can be expected in the future, with the high value of the yen providing an additional incentive. It may be unrealistic, however, to expect very dramatic changes in the short term, for the reasons discussed above.

Canada's Ride on the Coattails of the United States

Another strand in Canadian foreign policy has been its tendency to ride on the coattails of the United States in influencing the policies of other countries. Canada by itself is not powerful enough to exert much influence over Japan. Instead, it has often relied on the leverage created by its close relationship with the United States to induce Japan to impose export restraints and to increase direct investment. This tendency has become increasingly evident since the late 1960s as the United States has gradually lost patience with Japan over bilateral economic issues and has pressured Japan to restrain its exports to the United States. For Canada, it has become an urgent necessity to follow the U.S. example and seek Japanese export restraints, because "when goods destined for the United States are blocked or restricted, it is convenient to divert them to the Canadian market, which can easily be flooded because of its much smaller size."[15] Japan, for its part, has found it difficult, once it has acceded to a U.S.

---

[14]These perceptions are drawn from a survey by Tsukuba University of 182 Japanese companies investing in Canada (with a response rate of 39 percent); and from Chinworth, "Japan-Canada Relations," p. 2.

[15]Langdon, *The Politics of Canadian-Japanese Economic Relations*, p. 30.

request for export restraints in a particular sector, not to accept a similar request from Canada.

An appropriate example is Japan's voluntary export restraints (VERs) on automobiles. During the 1979–80 period, following the second oil price shock, Japanese exports of small cars to North America substantially increased, while sales of larger, less fuel-efficient U.S. and European cars declined. Under these circumstances, the United States launched an intensive campaign in early 1980, spearheaded by UAW President Douglas Fraser, to get Japan voluntarily to restrain its auto exports to the U.S. market, as well as to build auto manufacturing plants there.[16] Soon after, Canada followed suit. Herb Grey, then Canadian Minister of Industry, Trade and Commerce, even "went to Washington in April, 1981 in an effort to concert policy with the United States."[17]

The United States and Japan came to an understanding in May 1981, with the latter agreeing to limit auto exports to the U.S. market to 1.68 million units in fiscal year 1980–81, a decrease of 7.7 percent from 1980. Within a month of this agreement, Japan consented to reduce its auto exports to Canada by 6 percent in the current fiscal year.

It is important to note that the terms of Japan's agreement to restrain auto exports to the Canadian market were relatively milder than those of its agreement with the United States. While the Canadian-Japanese agreement led to a decline in auto exports to Canada during fiscal year 1980–81, exports actually increased about 10 percent during calendar year 1981 because of the flood of cars in the first three months of the year. Canadian auto industry and labor leaders criticized the agreement, arguing that the United States had obtained much better terms in its agreement with Japan — greater restraint for a three-year period, instead of just for one year.[18] Thus, while the Canadian strategy of riding on the coattails of the United States is a successful one, Canadians do not necessarily win Japanese concessions strictly equivalent to those made to the United States. Japanese auto industry representatives apparently are much more susceptible to U.S. demands and are inclined to make greater concessions to the United States because of that country's importance for Japanese economic and foreign policy.[19]

Even after obtaining Japanese export restraint concessions, Canada has not found it easy to extend such restraints. In fact, the two countries went

---

[16]For details, see Gilbert R. Winham and Ikuo Kabashima, "The Politics of U.S.-Japanese Auto Trade," in I.M. Destler and Hideo Sato, eds., *Coping with U.S.-Japanese Economic Conflicts* (Lexington, Mass.: D.C. Heath, 1982), pp. 73–120.

[17]Langdon, *The Politics of Canadian-Japanese Economic Relations*, p. 50.

[18]Ibid., p. 51.

[19]Interviews with Japanese auto industry representatives, Tokyo, June 25 and November 22, 1985.

through very difficult negotiations in 1982 over extension of the VERs. Japan agreed to an extension of only six months after Canada slowed down customs clearance of Japanese autos at Vancouver for several months (just as France let imported Japanese video cassette recorders pile up at Poitiers between 1982 and 1983).[20]

Japanese auto restraints were extended further in 1983 and 1984, after another strenuous negotiation. In early 1985, suggestions that Tokyo would not continue voluntary controls raised a furor in Canada. But again, right after announcing the extension of the VERs for the U.S. market in late March, Japan agreed to "a vaguely worded arrangement" to limit its exports to 18 percent of the Canadian market for the 12 months ending March 31, 1986 — an arrangement not fully satisfactory to Canadian auto producers and workers.[21] In February 1986, the Japanese government announced the continuation of restraints for the U.S. market for a year beyond April. But a similar announcement did not immediately follow for the Canadian market, in part because the Japanese came to worry about the rapidly increasing share of South Korean cars imported into the Canadian market free of tariffs and quotas. It was only after protracted negotiations that Japan agreed to extend restraints for another year, with Japanese autos being allowed 21 percent of the Canadian market.[22]

In addition to depending on its leverage with the United States, Canada has used the threat of unilateral action to induce Japanese direct investment in the auto industry. This action sometimes has included harsh pressure tactics, such as the 1982 slowdown of customs clearance at Vancouver mentioned above and the 1983 recommendation by a federal task force that Japanese autos sold in Canada should have at least 60 percent Canadian content. Japanese auto manufacturers, however, have been reluctant to invest in production in Canada for a number of reasons. One is the small size of the Canadian market. In order to make a profit in Canada, a Japanese manufacturer would have to sell at least 50,000 units per year. If each of seven or eight Japanese companies produced 50,000 per year, the Canadian market would not be able to absorb them. For their part, Canadian officials argue that the North American market is a single entity and that autos produced in Canada can be sold in the U.S. market as "made in North America".

Geographically speaking, it is true that autos produced in Ontario can be more easily delivered to Chicago or Cleveland than to Vancouver or Edmonton. But apart from the local-content provisions of the 1965 Canadian-U.S. auto pact, Japanese manufacturers seem to be afraid that assembling autos in Canada — instead of producing additional autos in

---

[20]Langdon, *The Politics of Canadian-Japanese Economic Relations*, p. 51.
[21]Chinworth, "Japan-Canada Relations," p. 7.
[22]*Nihon Keizai Shimbun* (Tokyo), August 21, 1986.

the United States itself — might antagonize the UAW and policymakers in Washington. Indeed, some people in the U.S. auto industry are said already to be worried about the possible "backdoor entry" into the U.S. market of Japanese autos produced in Canada.[23]

Japanese investors in general have preferred to commit investment dollars in the United States rather than in Canada for three reasons. First, they perceive that the United States is more committed to capitalism than is Canada; second, they consider the United States to be more politically stable; and third, the demarcation between federal and state governments in the United States is clear, while the relationship between the Canadian government and the provinces "is sensitive," according to Kunio Nakamura, executive director of the Japan Information Centre in Toronto.[24] Over the past year or so, though, this view seems to have changed somewhat, with relatively more attention being paid to positive factors about Canada, such as long-term lower operating costs (including Canadian labor and utility costs) and the generally reliable quality of Canadian workers. There is some growing interest among Japanese auto parts producers to invest in Canada and a number of them have already established joint ventures and technology transfer arrangements with Canadian counterparts, either on their own initiative or through Pacific Automotive Co-operation, created in Toronto in 1984 by a consortium of Japanese auto manufacturers to facilitate technology transfers between Japanese and Canadian auto parts makers. Moreover, Nissan is planning to build an auto parts manufacturing plant in Canada to supply its auto assembly plant in Tennessee.[25]

In any case, it was the threat of protectionism through continued restraints and unilateral action that persuaded Honda and Toyota to build their auto plants in Canada.[26] Explaining why Japan acceded to protectionist threats by increasing automotive investment in Canada is difficult, since Japan is economically more powerful and less dependent on the Canadian economy than it is on the U.S. economy. One may say that Canada rode on the coattails of the United States again, though the evidence is not as clear as in the case of Japanese auto export restraints. What Keohane and Nye, two U.S. political scholars, have said about Canadian-U.S. trade relations may be applied to Canadian-Japanese trade relations as well:

---

[23]Interview with a Canadian auto industry official, Toronto, August 2, 1986.
[24]Gail Lem, "Canada luring diverse investment from Japan," *Globe and Mail* (Toronto), October 28, 1985, p. E14.
[25]*Nihon Keizai Shimbun* (Tokyo), September 16, 1986.
[26]Interviews with Japanese auto industry representatives, Tokyo, June 25 and November 22, 1985; and Ken Romain, "Imported car distributors hope for end to curbs," *Globe and Mail* (Toronto), December 17, 1984, p. B8.

> Although Canada depended on mutual trade more than the United States, Canadian trade was important enough to the United States that Canada had a potential weapon for retaliation. The deterrence value of Canada's ability to inflict pain on the United States would depend on her will to suffer great pains herself and she was often willing to do that because of asymmetric salience: the relationship was more important to Canada than to the United States.[27]

Canada, along with the United States and Australia, is one of Japan's most important suppliers of raw materials and agricultural products. One could argue, therefore, that Japan made concessions in auto investment for fear that Canada might restrict its supply of these materials. But one should recall that western provinces such as British Columbia and Alberta, which provide most of the Canadian raw materials and agricultural products exported to Japan, have been generally happy with their trade with Japan and would have objected to such linkage between two policy issues. The Japanese knew this. Thus, it would be more realistic to conclude that Canadian pressure on Japan on autos was not linked to possible retaliatory action in the other sectors.

Special Treatment for Canada

Apart from trying to increase policy independence from the United States and occasionally using U.S. leverage in dealing with other countries, there is a third strand of Canadian foreign policy relevant to Canadian-Japanese relations. Canada has tried to obtain a special exemption from restrictions that the United States has imposed on its allies and trading partners. In 1963, for example, the United States imposed the so-called interest equalization tax on its economic partners to prevent further capital outflow because of lower U.S. interest rates. Canada was granted an exemption "after Canadian officials showed their American counterparts that the two capital markets had become so integrated that the damaging effects in Canada would feed back into the American economy."[28] Canada was similarly exempted from two other measures intended to restrict foreign access to U.S. capital: the "voluntary cooperation program" of 1965 and the "mandatory direct investment guidelines" of 1968.[29] Immediately after President Nixon announced his new economic policies in August 1971 and imposed a 10 percent surcharge on all imports, Canada tried, but failed, to obtain a special exemption from the

---

[27]Robert O. Keohane and Joseph S. Nye, *Power and Interdependence* (Boston: Little, Brown, 1977), pp. 203–204.
[28]Ibid., p. 203.
[29]Charles F. Doran, *Forgotten Partnership: U.S.-Canada Relations* (Baltimore: Johns Hopkins University Press, 1984), p. 21.

surcharge. Because Canada wanted to secure U.S. concessions for itself alone, Canadian officials were not particularly receptive to the idea of Japan and Canada joining ranks to pressure Washington, as suggested by then Japanese Foreign Minister Takeo Fukuda.[30]

Another example occurred in late 1977, when the United States decided to impose so-called trigger prices on steel imports. Canadian steel producers sought and obtained "preclearance" on their steel exports to markets in the U.S. Great Lakes states and were able to expand exports to the United States.[31] In early 1983, the protectionist movement in the United States picked up momentum, reflecting a steadily increasing U.S. trade deficit brought about by high interest rates and the U.S. budget deficit. Canada began calling for a bilateral free trade agreement with the United States, hoping, at least in part, to be exempted from harsh protectionist measures that the United States might impose on Japan and other trading partners. And anticipating the protectionist sentiment that flared up in the U.S. Congress in 1985, Canadian officials seriously took up the free trade issue at the highest levels of both the provincial and federal governments.[32]

Japan has been distinctly nervous about Canada's moves to explore a closer trading relationship with the United States, fearing that it could be a prelude to a united and more protectionist North America.[33] In his January 1986 meeting with Prime Minister Mulroney, Prime Minister Nakasone said Japan would not object to a Canadian free trade agreement with the United States if it would promote freer trade globally.[34] David Culver, chairman of the Canada-Japan Business Co-operation Committee expressed a similar view from a different angle: "Japan-U.S.-Canada trade is a triangular event. We cannot maximize our trade unless the whole triangle is trading freely."[35]

A key question is not why Canada seeks special treatment from the United States, but why the United States often provides such treatment to Canada and not to Japan or its other major trading partners. Hobart Rowen, of the *Washington Post*, raised a similar question in August 1985: "Strange isn't it, that the United States last year had a [U.S.]$20 billion trade deficit ($22.2 billion in 1985) with Canada — exactly the size of

---

[30]Langdon, *The Politics of Canadian-Japanese Economic Relations*, p. 74.
[31]Hugh Patrick and Hideo Sato, "The Political Economy of United States-Japan Trade in Steel," in Kozo Yamamura, ed., *Policy and Trade and Issues of the Japanese Economy* (Seattle: University of Washington Press, 1982), p. 216.
[32]A.J. Sarna, "The Impact of a Canada-U.S. Free Trade Area," *Journal of Common Market Studies* 23 (June 1985): 299–318.
[33]Stewart-Patterson, "Japan nervous over Canada's moves toward U.S."
[34]Jeff Sallot, "Nakasone qualifies free-trade support," *Globe and Mail* (Toronto), January 15, 1986, pp. A1–A2.
[35]Walmsley, "Canada's Tense Trade Ties with Tokyo."

the deficit with Japan the year before — but no one in Congress...stands up to say that Canada is a threat."[36]

Three explanations are possible. The first is that Japan has had the largest bilateral trade surpluses of any country in recent years. But one should also note that, given the much smaller size of the Canadian economy, Canada's per capita trade surplus with the United States is far larger than Japan's, and that Japan's share of the United States' global trade deficit declined to about 30 percent in 1984 from over 45 percent in 1982.

A second explanation could be that the United States regards Japanese trading practices as particularly "unfair". Such a perception could be related to the U.S. frustration that Japan, as the second largest market economy, is not carrying out international responsibilities commensurate with its economic power.[37]

The third possible explanation is that the United States is willing to take a tougher stand in its trade relations with Japan because of a large asymmetry in economic interdependence between the two countries. Within the existing structure of Japanese-U.S. trade relations, the United States could produce virtually all of the things it buys from Japan and, therefore, could terminate trade with Japan if it wanted to. It would be next to impossible, however, for Japan to find a replacement for the United States as a large and stable export market and as a reliable supplier of raw materials and agricultural products. The same thing cannot be said of the Canadian-U.S. economic relationship. Because of the closely interlocking nature of the two economies and the extent to which U.S. capital is heavily involved in Canadian industries, there is more symmetry in the economic interdependence between the two countries.[38]

A final and somewhat related factor is that, to a substantially greater degree than are Japanese-U.S. relations or even European-U.S. relations, Canadian-U.S. relations are based heavily on multiple channels of private-sector, personal, and intergovernmental networks. Therefore, Canadian interests are more effectively communicated to the U.S. side. And despite the obvious disparity in Canadian and U.S. economic (and military) capabilities, Canada has been able to influence U.S. policy much more frequently than might have been expected.[39] By contrast, the U.S.-Japanese relationship is influenced more directly by the underlying power structure, reinforced as it may be by greater cultural distance. One should note, however, that because of its declining industrial competitiveness and deteriorating macroeconomic position, the United States has become

---

[36]Hobart Rowen, "Low Point in Japan-Bashing," *Washington Post*, August 1, 1985.
[37]Hideo Sato, "Japanese-American Economic Relations in Crisis," *Current History* 84 (December 1985): 406.
[38]Keohane and Nye, *Power and Interdependence*, p. 203.
[39]Ibid., pp. 24–37.

less capable and less willing of late to give special treatment even to Canada. This change is reflected in its attitude toward the softwood lumber, and shakes and shingles issues, its decision to subsidize grains exports to the Soviet Union and China, and in its tendency to seek reciprocity in the current free trade negotiations with Canada.

Conclusion

This study has examined three strands of Canadian foreign policy relevant to Canadian-Japanese relations. Canada has not been very successful in expanding its manufactured goods exports to Japan as part of the historical Third Option. It has been slightly more successful in obtaining Japanese concessions in the form of VERs by riding on the coattails of the United States whenever convenient. It has also managed to induce some Japanese manufacturing investment in the Canadian market, perhaps because it has been willing to suffer great pains to achieve this purpose. Canada has often succeeded — although with increasing difficulty of late — in obtaining special treatment from the United States because of the relatively close formal and informal ties between the two countries. Canada's tendency to ride on the coattails of the United States and to count on a special relationship with that country can be understood in the context of the historical First Option of maintaining the status quo with Washington, although the current Canadian effort to conclude a bilateral free trade arrangement also could be linked to the Second Option of greater integration with its giant neighbor.

In view of declining U.S. economic influence in the world and a dynamically changing international economic environment, it will no longer be feasible or possible for Canada to remain passively dependent on its southern neighbor. While continuing to maintain its relatively heavy reliance on the U.S. economy — which may be unavoidable for geographical and historical reasons — Canada would do well to diversify its foreign economic relations. Such a policy does not have to conflict with Canadian efforts to strengthen further its economic relations and institutional linkages with the United States while retaining its cultural identity and political sovereignty. In short, if interpreted flexibly, the Second and Third Options can be compatible and need not be mutually exclusive.

Japan is now under unprecedentedly strong pressures to open its domestic market to foreign goods and services, to increase manufactured imports, and to expand direct investments abroad. It can no longer count on export-led economic growth without being branded as "neomercantilist". The high value of the yen is obviously an additional constraint. Under these circumstances, Japan is in the throes of having to implement basic structural adjustments to its economy along the lines of those recommended by the Mayekawa Report. Canada now has an important and

timely opportunity, much more so today than in the early 1970s, to expand its economic relations with Japan, to promote Canadian investment and manufactured exports across the Pacific, to invite Japanese direct and indirect investment to Canada, and, with the United States, to maintain free trade through multilateral negotiations. While one cannot and should not expect any dramatic results in the short term, as suggested earlier in this paper, it would certainly be worthwhile for Canada to pursue a very active and persistent economic diplomacy toward Japan, both at governmental and at private levels. The opportunity should not be missed again.

About the Authors

Dr. Wendy Dobson was President of the C.D. Howe Institute until the end of February 1987, when she went on leave of absence to serve as Associate Deputy Minister of Finance in the Government of Canada. She was educated at Harvard and Princeton universities and holds a PhD in Economics from Princeton.

Hideo Sato is Professor of Political Science at the University of Tsukuba, Japan. A graduate of the International Christian University in Tokyo, he holds M.A. and PhD degrees from the University of Chicago. He has been an Associate Professor of Political Science at Yale University, and Research Associate at the Brookings Institution. Dr. Sato has co-authored four books on U.S.-Japanese relations, and has contributed numerous articles to leading international journals.

Recent Publications of the C.D. Howe Institute

- *Social Policy in the 1990s: Agenda for Reform*, Policy Study no. 3, by Thomas J. Courchene (forthcoming). ISBN 0-88806-138-2.
- *An Opportunity Missed: Analysis of the February 1987 Federal Budget*, C.D. Howe Institute Commentary no. 14, by Edward A. Carmichael (March 1987). ISBN 0-88806-170-6.
- *Shaping Comparative Advantage*, Policy Study no. 2, edited by Richard G. Lipsey and Wendy Dobson (February 1987). ISBN 0-88806-143-9.
- *Tax Reform in a New Light*, C.D. Howe Institute Commentary no. 13, by Robert D. Brown (January 1987). ISBN 0-88806-169-2.
- *Confronting Global Challenges*, Policy Review and Outlook, 1987, by Edward A. Carmichael (December 1986). ISBN 0-88806-141-2.
- *Ontario's Proposals for the Canadian Securities Industry*, Observation no. 29, by Thomas J. Courchene, with John D. Todd and Lawrence P. Schwartz (November 1986). ISBN 0-88806-137-4.
- *Monetary Policy in Transition: A Study of Bank of Canada Policy, 1982-85*, Policy Study no. 1, by Peter Howitt (October 1986). ISBN 0-88806-136-6.
- *Staying on Course*, C.D. Howe Institute Commentary no. 12, by Peter F. Bartha (October 1986). ISBN 0-88806-165-X.
- *Closing a Trade Deal: The Provinces' Role*, C.D. Howe Institute Commentary no. 11, by Murray G. Smith (August 1986). ISBN 0-88806-164-1.
- *New Stresses on Confederation: Diverging Regional Economies*, Observation no. 28, by Edward A. Carmichael (June 1986). IBSN 0-88806-135-8.
- *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation no. 27, by Richard G. Lipsey and Murray G. Smith (May 1985). ISBN 0888-06-129-3.